Preface

The following pages are the transcribed proceedings from the Federal Credit Institute's **"Workshop on Promising Practices,"** the first ever government-wide workshop to showcase the "best" projects, programs and practices in Federal credit management throughout the Federal Government. The workshop which was held at the General Services Administration Auditorium in Washington, DC on October 1-3, 1996, was sponsored by the Financial Management Service (FMS), the Office of Management and Budget (OMB), the Chief Financial Officers Council (CFO) and the Federal Credit Policy Working Group (FCPWG).

Thirty-eight (38) Federal agency projects and programs were presented at the workshop which have directly resulted in improved Federal credit management. Each project or program that was showcased at the workshop has been tested and has resulted in enhanced management efficiencies within at least one Federal credit granting agency. Of significant importance is that each of the practices and projects has the potential to be emulated within agencies with similar program functions or responsibilities with the bottom line being better service to agency clients and savings for the taxpayers.

The Keynote Speaker for the workshop**, John Koskinen**, Deputy Director for Management, OMB noted "These promising practices are important for us to share because the Federal Government must be more aggressive in working to improve its management of each step in the credit program process. These steps obviously include the design of programs to meet their objectives and to avoid unnecessary losses, credit extension, account servicing, special collections and asset sales and program evaluation.

Frank Kesterman

Director

Risk Assessment and Monitoring Division

UNITED STATES OF AMERICA

FEDERAL CREDIT INSTITUTE

PROMISING PRACTICES WORKSHOP

TUESDAY

OCTOBER 1, 1996

The Workshop met in the GSA Auditorium at 18th and F Streets, N.W., Washington, D.C., at 9:00 a.m., Frank Kesterman and Thomas Stanton, Moderators, presiding.

PRESENT:

FRANK KESTERMAN	Moderator
THOMAS STANTON	Moderator
CHRIS BURNER	Speaker
PARKER DEAL	Speaker
DAVE DEXTER	Speaker
MIKE DOWD	Speaker
GERALD FERENCE	Speaker
TED FOSTER	Speaker
CHRIS GREER	Speaker
WALTER INTLEKOFER	Speaker
JACK KERRY	Speaker
JOHN KOSKINEN	Speaker
RICHARD MANUEL	Speaker
ARNOLD ROSENTHAL	Speaker
STEVE SOLOMON	Speaker
PETER ZORN	Speaker

AGENDA

P-R-O-C-E-E-D-I-N-G-S

9:21 a.m.

MODERATOR KESTERMAN: Good morning. Welcome to the first Government-wide Workshop on Promising Practices in Credit Management. I am Frank Kesterman. I work for the Financial Management Service, Department of the Treasury. I will be one of your hosts for the next three days. I want to publicly thank GSA for this wonderful facility and their extremely competent staff for helping us through this maze of equipment. So thank you GSA.

It is nice to see so many people out there, at least that is what my script says. Friends, and colleagues, this is a workshop. So we invite you to meet your neighbor, share experiences, and ask questions of these panelists. We have brought in what we think are the best programs, projects, and practices throughout the entire Federal Government. We are also integrating a lot of different types of agencies and programs that have never talked to each other. So we hope there will be some cross fertilization from mixing programs.

We have recorders for all sessions, so there will be transcripts available at the end of the symposium. Leave your address outside, and we will send you a copy of the proceedings after we get them edited and printed. Please spend time with the exhibits. These are not ordinary exhibits. A number of them are part of the presentations that you will be seeing by the panelists. They have been selected because they, in some cases, won Hammer Awards, and others because they are used by multiple agencies and they have been set up at great cost and time to give you hands-on experience with some of these software programs.

Our keynote speaker, Mr. Koskinen, as you probably got through the rumor mill, will be here at 1:30, he had an unavoidable scheduling problem. We will be televising at 11:30 to 12:30 and 2:00 p.m. to 3:30 p.m. each day. The format that we will follow for panelists is each panelist will have 10 minutes to present his or her presentation, and then we will have questions open to any of the panelists after that. We have scheduled a minimum of 20 minutes for questions and answers. So if you can, make notes, but please hold your questions until later. We have microphones in the audience. There will be people to hand you a microphone if you would like one.

My co-host is Tom Stanton. Tom is well-known to many of you. He is a fellow at Johns Hopkins University. He is a noted author and advisor on Federal programs. Tom and I are learning the teleconferencing business together. We tried to get Tom Brokaw and Ted Koppel, but they had more important things to do and they wanted to get paid. So will you please work with us. Tom will now give you some of the previews of today's program.

MODERATOR STANTON: The only thing I am sorry about is that we don't have a more congenial room for a seminar kind of structure. The whole purpose of this drill, and we have few people that can pull it off, is to get some real interaction. The whole purpose of this drill is for people to see the best things that individual programs are doing, take a look at it and say, yes, we could adapt something like that to our own program. So let's take advantage of the fact that we are few in number and really turn it into more of a seminar kind of spirit and more of an interactive kind of structure.

My job at the beginning of each half day will be to give you a sense of what is coming, sort of a quick synopsis of what is happening. For this morning's panel, what we have are a number of speakers talking about issues relating to loan origination. We structured the program so that it goes loan origination, loan servicing, and so forth down the line sort of each stage of the credit cycle, so that each of you with your own programs in mind can think about the ways that this might apply to you.

The first speaker today, Richard Manuel from the Department of Housing and Urban Development (HUD), is going to talk about the Credit Alert Interactive Voice Response System (CAIVRS) which you already probably know. Basically what this is, is a tool. What we are always struggling with in Federal credit programs is that we can't be like a private business and just go out there and make the loan and then really make sure we collect on that loan and really hammer that borrower until they pay and then collect on that loan. What we have got to do in the Federal Government is have an overlying public purpose, and CAIVRS is a classic example. If somebody is a bad actor or not credit-worthy, can't handle their loan, then we want to know that up front. If they have had problems with one loan, you know that you can touch base with HUD and find out what is going on and make sure you don't make another loan to that same person and get into similar difficulty.

Dave Dexter is going to give us a couple of presentations, one involving a very sophisticated and in-depth set of matches that the Department of Education runs along the line of CAIVRS. Then he is also going to talk about the National Student Loan Data System. I don't know if any of you had a chance yet to see the exhibit outside of Ginnie Mae and "IPADS" and "CPADS" and the way they contract their originators, the way they contract their servicers and the way they can get loan level detail, which is really awesome. The Department of Education has had some trouble there. They have got these big structural things in-between them and the banks called "guaranty" agencies, and the guaranty agencies sort of decide you want a number and well maybe I will send you a number, or you don't want a number and maybe I won't send you a number. And some of the numbers get very fuzzy by the time they get to the Department of Education. The National Student Loan Data System is Education's effort to get beyond that and say we need real numbers here and we've got to have the kind of quality that we can all see out there with Ginnie Mae.

Michael Dowd of the Small Business Administration (SBA) is going to talk about three types of SBA lenders and the way they are tracked on a performance basis. A lot of agencies are getting hammered in terms of your available FTEs, downsizing, and performance-based structuring of the participants in your program. I will be asking you a question later, Dave, about structuring schools the same way. It may be a way to reduce your auditing requirements and reduce the demands on your staff time.

We are going to take a break, and you are going to have to bear with us with all the timing, because we've got people dropping in and out of this program. The next session is going to be on a variety of credit risk issues including, Eximbank, where they analyze the quality of the borrower and decide what kind of fee they have to attach to a loan in order to hit their OMB credit subsidy number for the amount that they are appropriated every year.

We have a great presentation from Chris Burner of Agriculture on a credit subsidy spreadsheet model to figure out if you give more of a subsidy to a few people, can you make less loans. But if you give less of a subsidy, can you serve more people and show the nature of those trade-offs in terms of credit subsidies. We are going to have a presentation from Freddie Mac, which is really awesome in terms of their "Loan Prospector" and the way they get credit scores and the way they figure out whether this borrower is going to be able to handle the credit that we are making, or alternatively, is this a borrower that really could be served by the private market.

Then we are going to talk about centralized servicing. I know there are a number of agencies that aren't allowed to close field offices. We saw an appropriations bill for VA closed down recently when somebody tried to close an office in Alaska. But SBA has had a lot of success. What you are going to see here is the way new technologies give tremendous efficiencies to centralized servicing, so in fact you can do a better job with less people very often through centralized servicing. At that point, we are going to break for lunch. That second session will be on TV, so you will have to excuse lights that will come on. Then John Koskinen will join us after lunch and at that point I will try to give a pre-cap of what is going on in the afternoon. Thank you.

MODERATOR KESTERMAN: Richard Manuel from HUD is going to explain CAIVRS to us.

MR. MANUEL: Good morning. To show you how important I thought this session was today, I want you all to know that I did give up my tickets today to the Baltimore Orioles/Cleveland Indians game at Camden Yards. I do have tickets for the 6th and 7th game of the World Series at Camden Yards, so those are the ones that I really am going to make sure that I go to.

How many of you have heard of CAIVRS? Okay, there is a fair number of you. It stands for Credit Alert Interactive Voice Response System. It started at the Department about 1986, and we had found through some audits that were done that we had a lot of multiple mortgagors that had defaulted on loans, so we developed a list at the time that was called the "Problem Mortgagor List." A mortgagor, for those of you that are not in the home lending business, is another name for borrower, and actually I am trying to start using borrower more because sometimes it is hard to remember mortgagor, and mortgagee as being the lender.

It started in 1986 simply as something that we looked up each time we did an Federal Housing Authority (FHA) insured loan. Obviously with the downsizing, re-engineering, and stuff that is going on, it is a good thing that we don't have that system anymore. That system was later turned into a computerized system based on social security numbers and employer identification numbers that the Internal Revenue Service gives out.

The system was developed by HUD/FHA, and the early users of the system were limited to the FHA “Title One Program," which is the home improvement program, "FHA Title Two Program," which is the FHA's main program for insuring single family homes, and then the "312 Program," which is a program administered by the CPD, Community Planning and Development, was added to it.

Since that time, six departments or agencies are now participating in CAIVRS. The first agency that came on-line as part of the system was the Veterans Administration with their loan guarantee program. After Veterans Administration, the Department of Agriculture with the Farmer's Home, the Department of Education, Small Business Administration -- those three came on-line at about the same time. The latest department to become involved in CAIVRS is the Department of Justice. Those are the departments or agencies that are participating at the present time.

The way the system works is that there is a phone number that a user would call. They call the phone number and then they are asked for an access code, you cannot enter the system unless you have an access code. You get an access code and then you enter either the social security number or the employer identification number. Almost instantaneously, the system comes back and tells you that there are no claims or defaults on this borrower, and if there are no claims or defaults on the borrower, they give what is called an "A" code, which is an acceptance code. If there is a claim or default, they give you another code, a "C" or a "D" code. A very important part of the system is that the system also gives the phone number for the individual that is getting the information to call in case they need to check on it further. If you call and if you get a claim on an FHA loan, you are given a phone number to call if you want any more details. If you get a claim on a SBA loan, you are directed to a phone number there. The lender is then able to find out any additional details in case the borrower happens to dispute the fact that there was a claim or default.

Basically, that is the way the system works as far as reporting. One thing that is key to the system is there is an audit file that basically is maintained forever. The purpose in this audit file is occasionally we will get a lender, particularly when we used to do it all by voice -- we do it a little bit different now, and I will explain that in a few minutes -- but you would get a lender that would have a borrower and they would put on the credit worksheet an "A" code. You would come in to endorse the loan, and you would find out that that wasn't true. So you contact the lender and say what happened, and they say that is what we got, that the borrower was good. We have a way to check and go back and see if that lender did call and to see what kind of response they got. So that there is no way to really fool the system. We know if the lender called and we know what response the lender got on the individual case, and that audit file is maintained forever.

The system also will report up to 10 actions against a borrower. So that if you have got a real loser that has 25 claims or defaults or something, you won't get all of that information. You will only get 10. And as I understand it, the 10 pieces of information are given back on a random basis except that the Department of Justice will get judgments against borrowers. The Department of Justice, if there is a judgment, that judgment is given first and would always be given in case there is a borrower that had a number of actions against them.

You can't participate in the system unless you actually have an agreement with HUD, you can't just go in and access it. So if your department is interested, I will give you a name at the end to contact. Also, the system cannot be accessed by credit bureaus or any other individual. The system is updated monthly. It is updated by an ASCII tape sent to the department and the borrower information is updated. We give lenders access to the system. The access information is updated weekly and the borrower is updated monthly.

The way we update the borrower information is we actually erase the file and rebuild it. When we get the tape from SBA, it is not something that is built on what is already there. We erase what is there for the SBA and then we rebuild the system. There also is a procedure built in, in case of mistakes. All participating departments or agencies have a mechanism for suppressing social security numbers. Social security numbers are the basis for this system, and if someone is reported by HUD and we find out that someone keyed in a social security number incorrectly, there is one person in each of our 81 field offices, that can go in and suppress the system.

One of the things that I think is very important is to remember that this is only an alert system. "CAIVRS" does not reject loans or approve loans. It simply alerts the lender or the department or the agency of what has transpired on this borrower in the past. So it does not approve loans. Each department has to set up their own underwriting criteria as to how they use this system. The way we use it at FHA is that if there is an FHA claim, we say that the borrower is eligible three years after the claim has been paid. That does not mean that they can automatically get a new FHA loan. It just means that they are not prohibited from getting one. Within three years, they would only be eligible for very, very unusual extenuating circumstances which typically would only be something related to health. We are very, very tough on the extenuating circumstances, and we don't think that three years is a long time to wait after the Government has paid a claim. In our underwriting with other agencies, we do require evidence that satisfactory repayment efforts have been made, and then we would make the loan.

I want to tell you very quickly how we use this system, because we don't use the voice-activated part. We have a computerized loan origination system that is called "CHUMS," Computerized Home Underwriting Management System. We have another system that is called "CLAS," which is "CHUMS Lender Access System." We find out about a loan at the date of loan application. All of our process is delegated and I don't want to get into that detail, but when a lender gets an FHA case number, they give us some basic information. One of the pieces of information they give us is the social security numbers on the borrowers. They give us this information through a computer system that goes directly from their system to our system. One of the things that is checked at that time is CAIVRS. So it is done by computer and we give them back, as part of the process, the case number and the information from CAIVRS. We check it again at what we call loan endorsement, which is the process where we are actually obligated on the loan. We again check CAIVRS to see if anything has happened between loan application and loan endorsement, and again we pass it back to the lender.

So we are actually checking it via computer. It is done at the present time on what is called a store and forward basis. It goes in to a mailbox and then it is picked up. Sometimes there can be a delay of 10 or 15 minutes in getting the information. We are in the process of putting our CLAS system, or CHUMS Lender Access System, on the Internet so that we will be actually doing this on a real time basis and the lenders will be able to access us via the Internet. The last thing I wanted to mention is that if you work for a department or agency that does not participate in CAIVRS, and you are interested, the person at the department to contact is a gentleman by the name of Mike S-C-H-A-U-E-R. Mike's phone number is (202) 755-5027. If you would call Mike and he would be happy to work with you in exchanging information. We don't supply information to agencies or departments unless they also give us data to build our data base. Thank you very much.

MODERATOR KESTERMAN: Thank you, Richard. CAIVRS is a real success story. It is probably the first government-wide surveillance system for guaranteed loans. I remember back about four years ago when it was a HUD only system and how much difficulty it was to gradually get all the agencies to start to share information. Congratulations on an excellent program.

Our next speaker is Dave Dexter, who has several topics -- Department of Education.

MR. DEXTER: Good morning. What I would like to do over the next several minutes is walk you through several computer matching programs that are conducted by the Department of Education to verify the eligibility of our student loan and student grant applicants. The presentation this morning is really in two parts. First I would like to walk you through six computer matches we do with other federal agencies to establish and verify eligibility for our loan programs. Secondly then, I would like to talk a little bit about some internal matching we do at the department via the National Student Loan Data System.

Before I talk about the matches, I would like to give you an overview just for a couple of minutes of what the student loan programs look like. I think you will be able to appreciate our computer matching when you put it in context of what the programs really look like. We are right now loaning about approximately 30 billion dollars a year. These are statistics for the year just ended. We have roughly 10 million applicants annually. We are making 7 million loans to about 5.5 million borrowers. The average loan size is about $4,200.00. As you can see, we make a lot of loans in a relatively small dollar balance.

Also, our program -- I think it is important to understand the structure that was set up under the Higher Education Act, it makes it relatively complicated to administer this particular program. We are dealing right now with roughly 7,500 post-secondary education institutions. These include schools ranging from short-term trade schools to two-year colleges, to four-year colleges, and to graduate and professional schools. We also have 7,500 lending institutions across the country participating in our guaranteed or federal family education loan program. In addition, we have 35 guaranty agencies, almost one in every state, that serve as guarantors of the loans that are made by the lenders. The U.S. Department of Education then reinsures these loans via the guaranty agencies. There are roughly 60 secondary markets also handling student loans. I am sure most of you are familiar with the Student Loan Marketing Association, Sallie Mae. That is one of the many players. There is Nellie Mae in New England, and on and on. So there are a lot of secondary markets in this particular program.

We also have multiple programs; students can borrow under the Guaranteed Student Loan Program, both subsidized and non-subsidized loans as well as PLUS loans, those are loans to parents. We have just recently, over the last couple of years, launched a direct student loan program. There, students may borrow either subsidized or non-subsidized loans and we also have parent loans. So that context -- again, what I would like to talk about is how we screen 10 million student loan applicants every year to insure that only individuals who are eligible for the loans receive them. One of the first matches we do is with the Social Security Administration. This match does two things. We verify the social security number of the applicant. We also verify citizenship status. We run roughly 9.5 million to 10 million applications through SSA files every year. We identify fraudulent numbers and deny student loans to those individuals who are supplying incorrect or fraudulent numbers. Obviously, this particular match is extremely cost beneficial. Our ratio is roughly 1:27. We are spending about $900,000.00 a year administering this particular match with the Social Security Administration, and our return is over 25 million dollars. These are loans that are not made to individuals who are not eligible. It also enables us to increase loan collections on the back-end in light of the fact that we do have the correct social security number, which is a key identifier obviously for tracking defaulters. This match also verifies citizenship status which is extremely important particularly in light of the recent immigration reform legislation.

Our next match we do with the Immigration and Naturalization Service (INS). Under this particular match, we verify the alien status of non-citizen student aid applicants. Most non-citizens are not entitled to student loans although there are various classes of individuals who, while they are not citizens, are still eligible to receive a student loan. This match with INS basically verifies the correct immigration status of these individuals. We match our student loan application file with INS' alien status verification index and this involves roughly 800,000 applicants who are verified against this data base of about 23 million records. It results in cost avoidance obviously for the Department of Education and also provides some administrative savings to schools who are dealing with a student loan applicant at the school level.

We also do a computer match with the Justice Department(DOJ). There is a provision in the Anti-Drug Abuse Act, Section 53.01, that requires federal agencies to deny certain federal benefits to individuals who are involved and convicted of either trafficking or possession of drugs. One of these federal benefits that may be denied is a student loan or a student grant. We are now required under this particular piece of legislation to do a computer match with our student loan applicant file against the Justice Department's database of individuals who have been convicted of trafficking or possession of drugs and deny certain benefits. This is somewhat like looking for the proverbial needle in a haystack. DOJ right now only has about 2,500 individuals in its database that have been denied these benefits, and of course we are matching it against almost 10 million student loan applicants. It is another eligibility hoop that we jump through in order to meet the requirements of the law.

Another match we do is with the Selective Service System. There is another requirement in the Higher Education Act that individuals who are required to register under the Selective Service Act, and I believe that is all males age 26 and younger,can not receive a student loan if they have not registered with the system. Well, how do you verify the registration and whether or not an individual has met that requirement. Obviously, what we do is a computer match with the Selective Service System to verify the registration. For those individuals who have not registered, this match also provides an opportunity for them to register and for those that don't, obviously they do not get a student loan.

This particular match is kind of interesting. It is with Internal Revenue Service, and we just recently set it up as part of our Direct Student Loan Program. Under the Direct Student Loan Program, borrowers can elect a repayment option that is called "Income Contingent Repayment Plan." What this means is that basically a borrower can repay his or her loan contingent upon the individual's income. Obviously, as income fluctuates throughout an individual's career, the repayment amount fluctuates. And to verify the income of the individual, we pull down the adjusted gross income data from IRS and that helps us establish a repayment schedule for the following 12 months. By the way, individuals that elect this repayment program must sign a waiver allowing us access to the IRS records. If not, we are not allowed to use the information because of disclosure provisions.

Finally, we heard a little bit about CAIVRS. I just want to mention one aspect of CAIVRS that has been very, very beneficial for the Department of Education. We are one of the largest providers of data to CAIVRS, almost 2 million records from Education reside in CAIVRS. The real benefit to us right now is that individuals who have defaulted on student loans and are now trying to get FHA financing are turned down via CAIVRS because they are in default on another federal debt, specifically a student loan. A lot of these individuals are now willing to repay the Department of Education the $2,000.00 or $3,000.00 or $4,000.00 or $5,000.00 or whatever it is that they owe us so that they can get a green light via CAIVRS to go ahead and purchase a home with FHA financing. So it has been very, very helpful to us in that respect.

I want to move on to internal matching. But before I do, on five of the six matches I just mentioned with external agencies, we all are required to meet provisions of another piece of legislation called the Computer Matching and Privacy Protection Act. When agencies do computer matching, most of these matches fall under this particular piece of legislation, the Computer Matching and Privacy Protection Act. It has a number of provisions that agencies have to follow before you can do these matches. Before this law was passed, Congress was concerned about the big brother aspect of agencies matching other records and information leaking out, et cetera, so they passed this particular law. Among other things, agencies need a formal agreement between each other to do the matches. Each agency that is involved in matches has to have established an entity called a data integrity board that is made up of senior officers in the department that approve these matches. The matches all need a cost benefit analysis and safeguard provisions for the data. It is a rather time consuming process but certainly insures that individuals' privacy rights are protected.

The last part of my presentation, I just want to spend a couple of minutes talking about internal matching -- what the Department of Education does internally to verify the eligibility of student loan applicants. The system we use for this is something called the National Student Loan Data System. It is one of the world's largest interactive data bases. It now has almost 80 million individual loan records in it. It was created just over the last few years at a cost of about 23 million dollars. It is also costing us roughly 23 to 27 million dollars annually to operate.

I think it is important just to step back for a minute to understand what we did before we had this particular system. Before we had NSLDS, our only access to loan data on an individual basis was an annual submission we got from the guaranty agencies that administer our Guaranteed Student Loan Program. This submission was perhaps appropriately called a tape dump. Our 35 to 45 guaranty agencies at that time would submit a tape of the history of all of the loan records for individuals whose loans they have guaranteed. So we got 35 to 45 tapes in from the guaranty agencies. We would put them into a master tape and we would have a snapshot of where things were. Obviously, this was very, very awkward and was very difficult to match that tape, which always came in at the end of the fiscal year plus six months preparation, and to match that date against current student loan applicants. You can see the gap in time. This is an on-time, live, real system that enables us almost instantaneously to verify various eligibility requirements for student loan borrowers.

One of the key matches that is done in NSLDS is checking for prior defaults. Under the Higher Education Act, the student loan borrower cannot take out another loan if he or she is in default on a previous loan. And likewise, if the individual is also in default in repaying an overdue amount or an overpayment on a grant, the individual is also denied future loans. So this is a key match that we do, and it has been very, very cost beneficial to us. Over the last 12 months, we have been able to save or cost avoid, if you will, approximately 230 million dollars in loans that did not go out to individuals because they had defaulted on previous loans.

Clearly, we are not giving out loans to prior defaulters, and there is an additional savings here. If we weren't doing this match, we would not only be giving out money to individuals who are very likely to default again, but moreover under the Student Loan Program, individuals have their interest paid on the loan throughout the term of school. So if you are subsidizing students' interest payments for four years of college and then the student defaults, you can imagine the cost that is incurred. So right now we are saving about 230 million dollars a year under the National Student Loan Data System.

One last match that we conduct under the National Student Loan Data System is something called "loan limits." They are both annual limits and cumulative limits in terms of how much a student can borrow. As you can see, there are a variety of different categories depending on whether a student is dependent or independent and also what year the student is in college. This continues on to your third and fourth year students, and also you can see that there are cumulative limits that a student can borrow over time, depending again on whether they are independent or dependent or graduate students. Now how do you determine with 10 million kids applying for student loans where they are in terms of their loan limits, whether it is the annual or the cumulative. The only way you can do this is with something like the National Student Loan Data System. This has been extremely effective for us enabling us to control the amount of borrowing that applicants are applying for. With that, that basically concludes an overview of some of the matching that we do for eligibility purposes.

MODERATOR KESTERMAN: Thank you, Dave. When Tom and I interviewed Dave Dexter about what was going on in the Department of

Education, we were really impressed with all of the advances that have been made in information handling. We have another program on Thursday that is dedicated solely to the Direct Student Loan Program.

Both of our speakers mentioned CAIVRS. I just wanted to make a little announcement that I remember when Tom Stack was pushing CAIVRS to everyone. It is now a success, Tom, thanks to a lot of your pushing.

Our next speaker is Mike Dowd, who is going to explain to you how and why SBA has three different levels of lenders and how SBA benefits from that.

MR. DOWD: Good morning. I don't know about you, but I definitely have some questions for Richard after the session is over. I have got four kids between the ages of 17 and 23. Three are in college already. I am certainly going to try and find out what an independent student means. $46,000.00 is a nice piece of change to get for education.

I am going to talk a little bit about the SBA's three tiers of lenders. Before I do that, I would like to give you a little bit of background as to what it is that the SBA does. The organization began as an independent agency in 1953. One of its main functions at the time and one of its main functions to this day is to help provide financing to small business when that financing is not otherwise available on reasonable terms. Certainly, we are not in competition with banks or other private sector lenders, and yet the mission is that of trying to help those small businesses get money when they need it and can't get it through their local banking community.

When we began in 1953, from what they tell me, we were pretty much acting as any commercial bank would in the community. Congress appropriated a certain amount of funds to the SBA and with those funds we would lend out individually to small business concerns. Over the past 45 years or so, we have evolved from a direct lender of government funds or taxpayer-based funds to a guarantor of loans made by private sector lenders. As we all individually as businesses tried to leverage their funds, in effect we are doing the same thing. We can get an awful lot more leverage out of guaranteeing money made available by private sector lenders than we can by using dollar for dollar taxpayer money and lending that out on a direct basis to small businesses.

So over the years, we have moved from an organization lending all of its appropriated funds on a direct basis to one where in fiscal 1996 just completed, all of our financial aid or assistance went out in the way of guarantees. Over the years, we have guaranteed anywhere from 90 percent down to 50 percent of various types of loans. The average in the fiscal year just completed is probably about 77 or 78 percent -- maybe a little bit lower, maybe 75 percent. The role that we play in providing funds to small businesses is very similar to the role

played by commercial lenders. The difference is that we are a government organization and lenders are out there doing it for profit. Over the years, the principle kind of financing that SBA makes available is longer term type financing because the banks don't do that. The banks ordinarily do lines of credit, demand notes,
and so small businesses looking for long term capital to buy real estate and to provide ongoing working capital needs is not generally available through the banks. Large businesses have that kind of capital available by means of issuing stock, selling stock, and using interest around notes, but small businesses don't have it available without the government playing a role in this in the guarantee of the loans.

When we first began moving away from being a direct lender into a guarantor of bank funds, there was certainly a degree of training, a degree of bringing the lenders up the learning curve to understand what kind of policies and procedures the SBA was implementing in getting this assistance out to small businesses. That was a somewhat time consuming effort. And so as we were moving SBA people away from retail banking in a sense or retail lending, we were looking at every single loan application. We were spending more of that time educating the banks as to what our procedures were about. Over the years, some banks picked up on the program very well. They became high volume lenders. They developed performance records on SBA guaranteed loans that were commendable. And in the mid to late 1970's, we realized that there was a certain amount of duplication being exerted between or among both the SBA and the lenders that we were dealing with.

So you had lenders out there looking at the capital needs of their small business loan applicants. They were going through a certain amount of credit analysis themselves, as they ordinarily would do and as they are required to do by the various regulators. And then they would send the application into SBA and we would wind up going through the same type of analysis. We would look at repayment ability. We would look at the financial health of the business. We would look at the capability and competency and character of the principles of that business. In effect, we were doing all the same sorts of things that the banks were doing before they even sent the application down to SBA asking for the guarantee.

At the time, again in the mid to late 1970's, Congress started to appropriate some additional funding to the Guarantee Program, and the result was we were receiving more activity coming in from the banks, more guarantee applications, and yet without an increase in resources or in staffing, turnaround times were becoming poorer. So while it had been taking us maybe a couple of weeks to look at an application and get a response back to the bank or to the lender, we were finding that it was beginning to take three, four, or sometimes five or six weeks. Something had to give.

Considering that we were doing all this duplication in the credit analysis, we realized that some of these lenders were higher volume lenders. Some had very good payback histories on the guaranteed loans. So we said, let's try to rely somewhat more heavily on these lenders. We created a program called the Certified Lender Program where we authorized these lenders -- we kind of turned all of the responsibility over to these lenders to do a complete credit analysis, to do a complete SBA loan package, and to submit that to the SBA. We would simply review it rather than reanalyze it, and at a time when turnaround times were about five weeks, we cut the turnaround time down to three days. We made the banks very happy.

We would continue to monitor the portfolios of those lenders. Those who were found to develop a higher default rate or a worse loss rate than other lenders in the same categories, we would knock out of the program. So the CLP, the Certified Lender Program, actually developed into a pretty successful program.

About four or five years later, based on the success of CLP, we went one step further and identified those certified lenders who again continued to develop a certain significant volume of business and who had healthy loan portfolios, and those who were interested, we gave preferred status -- PLP, Preferred Lender Program Status -- which carried with it a significant enhancement, I suppose, to what the lender as a certified lender enjoyed, and that was the authority to place SBA's guarantee on the loan without SBA even doing a review of the credit aspects of the case. SBA continued to look at the eligibility factors, but we relied completely on the lender to do what it does -- to do what the regulators require that it does -- and that is to perform a credit analysis.

Well, we are still guaranteeing 70 or 75 percent or 80 percent of the amount of loan made by the bank, so we have got a vested interest in this loan, and yet we are not looking at the credit aspects of it. So how do we handle that? We have been developing much more precise monitoring systems, computer-based reporting systems, and we have just recently developed a centralized PLP or Preferred Lender Program Review System. In fact, the first one is going to take place next week. So the basic idea is that we are moving away from retail lending or retail analysis where you are looking at each individual case to one where we will be monitoring and then reviewing the portfolios of CLP and PLP lenders.

I should mention another aspect of the SBA re-invention and the SBA Loan Program re-invention that is along the same type of lines. It is the "Low Doc Program." Being mostly government people here, you know that we have got a reputation for requiring a certain amount of paperwork in all of our programs. SBA was no different, although those of us who have been in SBA for a while kind of thought that we didn't require an awful lot more than what a typical commercial lender would require. So we would want to see like three year's worth of financial statements. We would want to see resumés on management. We would want to see a business plan in effect.

Well, over the years, SBA was seeing that the average loan size, keep in mind Small Business Administration, the average loan size had been creeping up and up and up to where a few years ago it was about $250,000.00. The maximum that SBA typically can guarantee is only $750,000.00, and yet the average was up around $250,000.00. So when you look at that, you must realize that there is probably a lot of really small businesses, or at least businesses who are not -- who don't need a lot of money -- who probably, for whatever reason, aren't getting served by the SBA Guarantee Program. So, we looked at that and one of our former administrators went around and talked to a lot of banks around the country and a lot of small business groups. And what these two organizations or two groups were saying consistently is that it did take a lot of paper to get an SBA guaranteed loan and it did take a certain amount of time or too much time to get that done. So we developed what is known now as the Low Doc Loan Program for relatively small loans. So for loans of $100,000.00 and less, we have developed a system very similar to CLP and PLP that provides for only one piece of paper to be submitted to the SBA for a guarantee of a loan of $100,000.00 and less.

While if in the past we had been requiring three years of financial statements, resumés, business plans, how is that possible? The key element of that program is, like CLP and PLP, reliance on the participant private sector lender. So we receive only the one piece of paper, which on one side is summarized information from the small business concern and the other side is the summarized credit analysis from the lender. So we are receiving summarized data. The bank still receives all of the source documentation for analysis.

In the fiscal year just completed, about 50 percent -- in the year just completed, we will have guaranteed loans of about 10 billion dollars. Roughly about 56,000 businesses will have received guarantee assistance through the SBA.

Of that 10 billion dollars, about 25 percent of the dollars are being approved through the PLP program. Another 10 percent is being approved through the CLP program. And as far as the numbers, instead of about 55,000 loans that have been approved in fiscal 1996, of that amount probably 27,000 or 28,000 are being approved through the Low Doc System. So when you see those numbers, you can see roughly two thirds to 70 or 75 percent of all of the credits being approved now through the SBA, and this is a significant departure from where we had been only 5 years ago, are now going through either CLP, PLP, or Low Doc. Thanks.

MODERATOR KESTERMAN: Tom Stanton is going to manage the question and answer period.

MODERATOR STANTON: Let us collectively manage the question and answer period. I think we have heard three really neat presentations. Please -- and those of you who are from GAO or OMB or other non-credit agencies but who have a personal strong interest in credit programs, join in as well. Everybody is invited. Any questions for our panelists? And then we can sort of have discussion among ourselves. Let's do it sort of in a seminar style. We have got enough people here for that. Yes? And if you would identify yourself, if you want, that would help us.

MR. KERNAN: My name is Mark Kernan with the SBA. My question is to Mr. Dexter regarding the 230 million dollars in cost avoidance. You indicated that some of that amount was savings the government would have if they did this with a subsidy. Another part of it was not making these student loans. How many people are we talking about here in this 230 million dollars and what is the breakout between people who have actually used services in the savings versus the subsidy market?

MR. DEXTER: Okay. I trust everyone heard the question. With respect to the 230 million dollars that we have saved over the last 12 months using the National Student Loan Data System, we came up or we calculated that number based on a little under 100,000 individuals being denied new student loans because they had defaulted on a previous loan. It is our position that if an individual has stuck it to us once, they are very likely to do it again. There is your 230 million dollars roughly. We took our average loan size times the number of individuals identified.

Now in addition to that, I did mention the interest subsidy cost. We did not include that in the 230 million dollars. But had we let those loans go forward, the Federal Government would have been paying interest on those loans throughout the student's time in school plus 6 months grace period afterwards. We did not include that interest subsidy cost in the 230 million dollars. Does that answer your question?

MODERATOR STANTON: Other questions? There is a woman here from GSA who is giving us all this wonderful support system here who has a portable microphone so that we can all hear the question -- two people. Okay. Any other questions? Tom?

PARTICIPANT: Dave, on the match, do you or Ron have the number of people who have had numerous defaults (participant not at microphone and remainder of question cannot be heard.)

MR. DEXTER: I am not quite sure if I understood your question, Tom. Have we looked at -- in our match, have we identified individuals who have had multiple defaults?

PARTICIPANT: Prior to doing that, did you have occasions where you have had a lot of people who have defaulted on several loans?

MR. DEXTER: No question. Yes. As I explained a little bit earlier, I think it was before you came in, Tom -- I gave the pre-history before the National Student Loan Data System was in place. We would receive annual tapes -- the tape dump as I described -- from our various guaranty agencies. This information would only come in once a year. It was always put together at the end of a fiscal year and then there was 6 months development time to get all the tapes together. So we had an 18-month window where individuals could be continuing to apply for student loans and get new student loans whereas they defaulted in the last 18-month window. You can see what a nightmare we had before we had this National Student Loan Data System. Our analysis showed that clearly individuals were sneaking into the system and getting new loans when they had multiple prior defaults. Fortunately, the Congress ultimately appropriated the money for us to design and build the National Student Loan Data System, and the cost savings are really tremendous.

MODERATOR STANTON: Yes?

PARTICIPANT: I am just curious, when someone applies for an FHA loan and you see that they have defaulted on a student loan, does that work in terms of servicing the student loan? Doesn't it help out in locating where they currently are and things like that? Or does it just check the loan for the FHA loan?

MR. MANUEL: At least from our side, I don't think it is locating people. What I think it is doing is what David had mentioned. It is causing them to suddenly repay. It is kind of interesting and not unusual, I guess, that when you go through -- when interest rates are low and you go through a refinancing cycle -- even those that are not in the market know when that happens -- and we had a huge one a few years ago that lasted for almost three years, that really causes a lot of delinquent loans to be repaid. Whether it is the Department of Education or even doctors. Because they come up on credit reports and one of the things that we require is that they be repaid. In some cases, we don't necessarily require that they be totally repaid, but we do require the satisfactory repayment arrangements be made. And we typically do not allow someone to make a repayment agreement today and close on an FHA insured loan tomorrow. We don't have any set time frame, but we want arrangements and some history. So it can be a three-year repayment plan or something like that, and then we might approve the loan after they have paid for six months or something. And I don't think these people are lost.

MR. DEXTER: If I could just add a little bit to that. I first want to point out that when there is a hit in "CAIVRS", that doesn't deny that individual applicant eligibility necessarily for FHA financing. It is only a red light, if you will. It stops things until things are verified. So when there is a student loan default on the record, that stops the process. Now, on rare occasions, that student may have repaid his or her loan. There are phone numbers provided and there is immediate follow-up and those cases are indeed a rarity. But as I mentioned during my presentation, most of these student loan defaulters will repay their $3,000.00 student loan to get FHA financing.

MODERATOR STANTON: Yes?

PARTICIPANT: You mentioned a $3,000.00 student loan. Don't in fact, the interest and penalties most often double that?

MR. DEXTER: Absolutely. In fact, one of my slides showed that the average loan size now is about $4,000.00.

PARTICIPANT: I assume that penalties and interest are charged to the student.

MR. DEXTER: Absolutely. The interest clock continues to accrue. And moreover, we pass on all collection costs to the student, which can add an additional roughly 33 percent to the amount of debt.

MODERATOR KESTERMAN: Dave, I have a related question. Maybe it is better answered under the Direct Student Loan Program, but how will the Department gear up to handle all the variable income changes which are permissible under the new law?

MR. DEXTER: I think you are referring to the various repayment options?

MODERATOR KESTERMAN: Yes.

MR. DEXTER: To answer that, maybe I could just explain. Historically, student loans were required to be paid in even payments over 10 years basically. I mean, there were provisions for deferments and forbearance for unemployment and disability, but basically that was the old plan -- 10 years divided by 120 months, and you repay your loan.

Under the new direct student loan program, we now offer borrowers multiple repayment options. In addition to the standard 10-year plan, there is a graduated repayment plan, and there is also something that I referred to earlier in the presentation, the Income Contingent Loan Repayment Plan, which is basically based on an individual's earning power. As I explained, we do a match now with the Internal Revenue Service to verify adjusted gross income (AGI),. It is the only way that we can have complete confidence that we know how much an individual borrower is making. And based on that information, then we can lay out a repayment plan for the next 12 months. Obviously, an individual's earning power goes up and down. So this is an annual thing.

Again, the borrower has to sign a waiver allowing us to get AGI information from IRS. If the borrower does not sign the waiver, we are not entitled to get the AGI information, in large part because we use contractors for much of the administration of the program, and we cannot disclose taxpayer related information to non-federal employees. So that is a problem.

Incidentally, I would point out that we are now also looking at a new computer match, and this is related to income and various repayment plans. And that is we are now looking at the possibility of checking income for all student loan applicants. There are various thresholds of income and what we call expected family income that are the basis for determination of whether a student can borrow or not. We are using 1040 information, but it very well may be more reliable and more verifiable to do tape exchanges with IRS and get the AGI right off of a tape. It would certainly cut down on paper and give us a lot more comfort in terms of whether or not a 1040 had been whited out and numbers changed and things like that.

MODERATOR STANTON: I would like to ask a question because I would like to see if we can get some interchange from people from various programs sort of looking to see if any of these ideas fit in terms of your own program. I guess I would like to ask a question of Mike Dowd from SBA and their three tiers of lenders. I am thinking we have Gerald Ference here from VA and we have people here from HUD and from Education. VA, HUD, and Education deal with say 8,000 in round numbers of lenders. Education deals in round numbers with 8,000 schools or something like that. And it struck me that a performance based tiering system, where you devote your serious resources to the ones that are low performers that are most likely to give you trouble may be a real resource saving approach for a number of agencies. My question for you, Mike, is were you able to implement this by yourselves or did you need to go to Congress for actual authorizing legislation?

MR. DOWD: We actually began it back in 1979 with the CLP program and a few years later with the PLP. My recollection is that we were able to do that without going to Congress for it. We also coincidentally deal with about 7,000 to 8,000 private sector lenders. The great majority of those are commercial lenders. There are also some savings banks, savings and loans, credit unions and organizations like that. Probably 60 percent of all the business that we do is through lenders who are active either in CLP or in PLP. So the resource savings, I suppose, to SBA is that you are taking credit analysts or loan officers away from the up-front side of doing the analysis and moving them on to the review side. Our feeling is that if you pay a lot of attention to reviewing the active lenders, then if you've got a well-performing, active core of lenders
-- we have 600 CLP lenders and maybe 350 PLP lenders
-- so out of the 8,000 private sector participants, 1,000 are in one of these two programs. If they are doing a good job and they are doing 60 to 65 percent of our business, we feel that we have gone a long way to creating a strong portfolio.

MODERATOR STANTON: Does anybody want to ask questions about potential barriers you might see in your agency to doing this and how SBA dealt with those or alternatively any thoughts on applicability of this across agencies?

MR. MANUEL: I have a comment. We have been -- this session has been interesting to me with the similarities in the way we do things. We have had a program similar to the certified lender program also for about 15 years. Ours is called "direct endorsement." At the present time, it is mandated. So we do everything with our Direct Endorsement Program and our lenders have to meet a certain standard. We also make a lot of use of what we call early claim and default information. We have decided that from a loan origination standpoint, typically a problem loan related to the origination side is going to show itself in housing in about 24 months. Problems beyond 24 months are probably things that no credit review could have showed. It is related to divorce or illness or something like that. So we monitor on a quarterly basis all of our loans through a 24-month cycle and actively look at the lenders to compare the ones that are doing well and the ones that are not doing well and take them out of the program.

We just -- and I know that different departments are able to do different things -- we just received within the last three days legislation that will allow us to start something like the Preferred Lender Program. And we are going to be starting to allow lenders to what we call endorse their own loans or issue the insurance certificates on behalf of the department. So we are going to be doing something very similar to what Michael is doing at SBA.

MODERATOR STANTON: There was a question right there. If you will wait for the microphone for one second.

PARTICIPANT: I actually have a question for Michael Dowd first with what we are trying to do. I guess what I am wondering is what kind of reaction you got from the lenders who are not put into the PLP tier and how you dealt with them?

MR. DOWD: That is a very good question. The PLP lender -- both the CLP and the PLP lender are almost by definition lenders who have an awful lot of interest in the program. They have developed a volume of activity, and we have required and do require that they develop and maintain a relatively healthy loan portfolio. So it certainly is a carrot and that certainly is one of the benefits to the SBA, that you offer the lender 3-day turnaround time at a time when the routine process is taking five or six weeks. That is an encouragement to that lender to sign me up. Well then when you give them the further enhancement of being able to place the guarantee on the loan themselves, which in effect also gives them a quicker turnaround time -- the process is simply they notify us. We have centralized that process. It used to be that they would notify one of our 70 offices around the country and now they notify one centralized location. So they have virtually instantaneous approval of the guarantee.

So those lenders who may have resented or didn't like the fact that a business might now be able to get better service out of a CLP or PLP lender had a choice. They could either say “I am going to become active; monitor me and I can show you that I will develop a well-performing portfolio and then I will want to move on to PLP.” Or they would have to sit there and sulk.

PARTICIPANT: Okay. When you first started this program, did any of the lenders go to Congress or to the Fed or the SBA and say they can't do this?

MR. DOWD: I am sure there were some, but considering that it was more than 15 years ago, not enough to make a dent.

PARTICIPANT: Yes, okay. I guess I did -- I almost hesitate to mention this because it is just in the process of building and I don't know, Mr. Dexter, if you are aware of this yet, but the institutional participant in an on-site service is developing a risk analysis. We are ways away from being able to do something like CLP or PLP, but if you look at the Ginnie Mae system that is set up out in the hall here, that is basically the kind of thing we are doing. We have got the same people who are building that. I guess I did have one other question for you, Mr. Dexter, and that was that most of the data matches that are happening at the central processing system -- the student's application is coming there, correct?

MR. DEXTER: Correct.

PARTICIPANT: What I heard you saying is that the IRS may be added to that point. But right now, for the IRS matches for income contingent payors, that is evidently just on the people that have indicated that they want to set it up that way?

MR. DEXTER: That is correct. The current AGI information we get from IRS is just for direct loan borrowers who elect to repay their loans under the income sensitive plan. Currently, that is a very, very small number because our direct loan program is very new and many of the initial recipients of these loans are still in school. Ultimately, yes, we are thinking of using the central processor as the matching location for all HEI information.

PARTICIPANT: Do you know if there are any legislative barriers to doing that?

MR. DEXTER: Unfortunately, there are. The IRS is extremely protective of its data -- all data. Taxpayer data is what they call it. Anything in your 1040 and all the other schedules is taxpayer data. And as I mentioned earlier, the only way we can get AGI information now for our direct loan borrowers who are in an income contingent repayment plan is for the borrower to sign a waiver and IRS has to keep a copy of the waiver. That is the only way they will release that little piece of information. We would have to do the same thing most likely to do a multiple match, unless that is for all loan applicants. Unless we find a statutory provision that we could tuck in somewhere that would require IRS to release that information for us. But they are extremely protective under the Internal Revenue Code with all of that information.

MODERATOR STANTON: Any other -- yes?

PARTICIPANT: A brief thought on the IRS status. If you are developing the system, I would like to know (participant not at microphone and remainder of question cannot be heard.)

MR. DEXTER: That is good. I am glad somebody is out there paving the road for us to make it a little bit easier. We do a lot of other matching, incidently with IRS. Everyone here I am sure is familiar with the Tax Refund Offset Program and we are bringing in over 500 million dollars a year on that. We also do address matches with the IRS to locate defaulters and to get fresh addresses. Every step of the way it is a challenge because of the Internal Revenue Code. It is nice to see that there are some breakthroughs and they are loosening up on some of this.

PARTICIPANT: I really don't know. I was talking to a facilitator at the IRS and they hope to have the results by the end of the year.

PARTICIPANT: Why couldn't we have, perhaps, a standard form for anyone who is getting a guaranteed or a direct loan that allows them to basically provide information that is necessary to show their gross income over whatever number of years that would be appropriate to be matched by computer with the lender that submitted an application?

MR. MANUEL: At HUD/FHA, we have been requiring a form that Internal Revenue has that will allow you to access information. We have been requiring all self-employed borrowers to execute that form as a condition of the loan. We have been doing that for about three years. We don't use it for originating a loan. We use it for quality control. We have been doing it for about three years, and it has been very, very successful.

The gentleman on the side over here, if we are thinking about the same demonstration, the one in California that I am familiar with was set up by the Mortgage Bankers Association and the Internal Revenue was active in it. They were using it for originations on self-employed borrowers, and they had agreed to a 24-hour turnaround. They were using -- you always have to get a waiver from the borrower, but there is a form for that. And the early results of the one in California that I heard of was very, very frightening. It was something like 45 percent of the information was different between what the person had shown on the tax returns that they submitted with the loan application and the information that came back from Internal Revenue. And the information that comes back from Internal Revenue is a one-page summary of the various lines. So it is not a copy. Years ago, you could get copies of tax returns, but they took a long time and they were actual copies. Now they give you a computer printout that shows you the items on the various lines but we have been using it for about three years in quality control and very effectively.

MR. DOWD: Let me just add to that an SBA comment. We also have been verifying tax returns for the past probably two years -- not the personal tax return as much as the corporate and the sole proprietor information. It has proven successful. We haven't found what Richard refers to, rather probably upwards of 95 percent of the information that we verified through IRS has been comparable or similar to what the small business applicants have been submitting with their loan packages.

MR. DEXTER: Just to go back to your idea, Tom. We would certainly endorse some kind of government-wide effort to make this more standardized, uniform, and easy to access. In terms of verifying some of this data, I know currently our Office of Inspector General is looking at tax return data. For students to get a student loan, there is something called an EFC, expected family contribution. The more the family makes, the more contribution they are expected to make towards their children's education, and obviously the reverse is true. Our Office of Inspector General has found that people are fudging on parent's incomes, which obviously enables more individuals to get student loans when they really shouldn't be or should be getting smaller loans because their parents are expected to contribute more. That is why we are thinking of maybe just doing it across the board. Again, if there was some kind of standardized government-wide form or process to access this data, and it is nice to hear it is coming out computerized, it would make it a lot easier for us.

MODERATOR STANTON: I have got one last question if I may, and that is to Mike Dowd of SBA. I can understand that in today's age of technology, everybody is trying to get faster turnaround for the borrower and there is a lot of pressure to go to Low Doc loans. I know that the commercial residential mortgage industry really took a bath on Low Doc and No Doc loans, and I am wondering if there are any safeguards. For example, Fair-Isaac and some of the other credit-scoring companies now have fairly respectable credit scores for small business. Have you considered building that kind of independent verification of credit-worthiness into your applications in any way?

MR. DOWD: That is a great point. We have indeed considered it. In fact, we have entered into a contract with Fair-Isaac, and we plan to implement their system once we centralize the processing of the Low Doc Loan

Program. Right now, Low Doc loans are being processed by virtually each and every of the 70 district offices that we have around the country and implementation of a credit scoring system is much more difficult when you are dealing with 70 offices than it would be when dealing with two or three centralized facilities. So we do plan to implement a Fair-Isaac type credit scoring system once we centralize.

Also, we have identified somewhat higher standards for Low Doc loans as to credit. So a company that comes in for a Low Doc loan that is owned by principals who have had past credit problems as evidenced by their TRWs or the personal credit reports are not eligible for Low Doc financing. They need to get a full-blown look by the SBA credit analyst.

MR. MANUEL: I have a comment on the credit scoring. One of the speakers that was mentioned is from Freddie Mac and the Loan Prospector. We are doing a demo with Freddie Mac on Loan Prospector which is going on right now. We are also starting to develop our own mortgage score card. We are very, very concerned about them, however, from some fair lending aspects, and we believe that the only real scorecard that could be developed that will meet fair lending requirements and the test of disparate impact is a scorecard that is built on your own population. So that it has to be an in-population set. So we basically are requiring and are going to be using ours. Our scorecard will be built based on FHA borrowers and on FHA's population. I don't think that we -- the way I see it right now, I can't see us ever actually recognizing one that was not built using our population.

MODERATOR STANTON: How are you dealing with it with respect to Freddie Mac?

MR. MANUEL: With Freddie Mac -- we have made data available both to Freddie Mac and anyone else that wants it. They have to sign up with certain conditions, but we will give data that can be used. Freddie Mac has a system that they have built using FHA data. That is one of the reasons that we are working on this demo. We have not recognized or approved anybody's system. So that if anybody ever hears that FHA or HUD has approved somebody's system, we haven't. But we are doing a demo with them.

MODERATOR KESTERMAN: Before we take a break, I have one last question for Mike Dowd. Mike, we have Halcyon outside as one of the exhibitors, and they have a standard load evaluation software program that I am told is being used in many SBA offices throughout the country. Do you care to comment on that?

MR. DOWD: Yes. It is a very fine organization. We have been working with Halcyon for probably three, four, or five years. They are one of a fairly small number of companies who have developed -- well, they are one of I suppose fairly many who have developed a credit analysis system. They are one of the relatively few who have developed an SBA loan package development system. So it is a fine organization. There are a number of companies doing this, and Halcyon is one of the best.

MODERATOR KESTERMAN: Thank you and congratulations on a well-done lender management program at SBA. We have more of your colleagues coming this afternoon and tomorrow. We will take a break now until 11:15. Thank you.

(Whereupon, at 10:50 a.m. off the record until 11:31 a.m.)

MODERATOR STANTON: Welcome to the second session. We are now on television, and when you ask your questions, you will have the opportunity to be heard not only by federal officials around the country, GSA -- and we thank you for this GSA -- has arranged for television downlink, but also for satellite downlink to anybody in the world who happens to be listening. So to our national and international audience, we say welcome. Welcome to the second session of the Federal Credit Institute's Program on Promising Practices.

In the first session this morning, we developed sort of a seminar kind of interchange. I was absolutely delighted to watch people from one program agency ask people from other program agencies about how certain of these promising practices work. We hope we can have the same kind of interchange again this late morning.

We are going to have three presenters. Unfortunately, our first one from Export/Import Bank couldn't be here. If you have been reading the newspaper, you may understand. Their budget is under some scrutiny from Capitol Hill as we speak. What our session is about this morning is credit risk review and various forms of credit scoring, credit subsidy analysis. Here is my co-host from the Treasury Department Financial Management Service, Frank Kesterman. He and I together had the great opportunity to go out and find people who were engaging in these promising practices and ask them all sorts of questions.

Our first speaker this morning will be Chris Burner from the Corporate Programs Branch of Commodity Credit Corporation, U.S. Department of Agriculture, and his is almost my favorite story. As Frank and I sat there in his office, he said, "You know, the air conditioner at home wasn't working, so I spent a lot of time at the office and had a lot of time to work up this spreadsheet model." It is a truly neat spreadsheet model, as you will see. It is something that several years ago I was trying to work up or a group of us were trying to work up for an AID credit program, and it was really hard at that time to get all of these present values of your expected defaults. Chris will now show us how to do it with new technologies and in real time. Then I will introduce each of the other speakers as we go. Chris, take it away.

MR. BURNER: I do have an air conditioner now, so I am not going to be doing any more of this work after work. So this is all we get. I will tell you a little bit about what this spreadsheet does. It is a Lotus for Windows spreadsheet that takes assumptions for loans programs and calculates the subsidy using OMB's subsidy credit model, I believe. It is a little intimidating to use if you are not good at computers, so this even takes out a little bit of the intimidation with OMB's cashflow model.

It looks like some of the blue lettering is not showing up very well, but I will try to explain most of what it does. What this spreadsheet will do is it will create the lines of cashflows as dictated by the OMB model, shell out to DOS, run the model, and then come back in and put new subsidy costs up on the screen for you. I have added a new button recently called "NEW," so you can create a new spreadsheet from scratch. The first dialogue box that pops up says, "Enter a budget title." It defaults to 1997 president's budget. We will just start from here. Next, "Enter a program name." We will call this one "test." The next dialogue box says, "Choose the appropriate program type." You can choose either a direct loan or guaranteed loan. We will just use direct. "Enter the loan term in years." It will only function using whole years, months is not an option. We will use 10. The payment options that we have are amortized, just like your regular mortgage or your car loans, or the second option is equal principal payments, which is large payments that decline through the life of the loan. We will use amortized. If you would like a grace period in your loan programs, here is where we can enter a grace period. I will put in 2, just so that we can see that it works. Fees with your program, we have four types of fees. The first option is no fees, commitment fees, non-capitalized exposure, which are fees paid at disbursement time, capitalized exposure, which are fees that are I guess assigned at disbursement time but paid along with the principal payments through the life of the loan, and then the annual payments. This is a direct program, so I will just go with no fees.

This particular program works for international programs. The first spreadsheets I developed were mainly for farm credit programs and rural housing, and they had a different set of assumptions -- different things like payments paid late, pre-paid loans, and defaults based on a percentage of the program. Since this is an international program, it is based on risk ratings assigned by -- who assigns the risk ratings, Peter? ICRAS, okay. We will say these are a C-rated loan. "Enter the first program year you want to calculate." It defaults to 1996, so I will stick with that. "Enter the 1996 program level in millions." We will stick with 10 million. "Enter the 1997 program level in millions." I will choose 10 for 1997, 1998, and 1999. You can calculate up to 12 years worth of programs. I will zero out the rest of them. It will not take as long and it won't ask me for as many inputs later. Zero for 2000, 2001, 2002, 2003, 2004, 2005, 2006, and 2007.

The next dialogue box that comes up asks for a disbursement rate for the first year. The OMB model likes disbursement rates in quarterlies. Whatever the quarterly rates are, it will estimate the subsidy based on those. I will just use what I have for defaults, which is 25 percent for year one, year two, year three, and year four. It will use up to six year's worth of disbursements. I will keep those at zero.

Excuse me, I got a little ahead of myself. Those first disbursements were for the amount of the program -- how long it takes for the program to go out. I put in 25 percent for year one, 25 percent for year two, and 25 percent for year three. Now these dialogue boxes are for the quarterly rates for each quarter for each year. So year one has 25 percent disbursement and now it is asking how much of that disburses in the first quarter, which is 25 percent in the first quarter, 25 in the second quarter, 25 in the third quarter, and 25 in the fourth. Now it is going to go back through and ask me what are the quarterly disbursements for what you put in for year two. I will just go through it at 25 percent for year two, and three, and four as well.

Now it asks for the discount rate for loan programs with 10 years of maturity. It looks to see how many program years I have put in and starts at 1996 and then looks at the term. So it is asking you the appropriate question at this time. I will stick with what I have for defaults, which is 7.5 percent, and 1997 as well, 1998, 1999, 2000, 2001, 2002.

The next set of screens are for the borrower rates. You can have an individual borrower rate for each year of the program as well. I have them defaulting at 7.5 percent as well. I will put in the first year at 7.5, the second year at 6.5, to show you what the differences are. The interest rate during the grace period -- I think I have already skipped one or two, but the interest rates during a grace period are usually less. I will put in a couple that are less so you can see what the effect is.

Now it says data entry is complete. Those are the only sets of assumptions that I have built into this particular spreadsheet. I just hit return again and it will shell out to DOS, run the OMB's credit subsidy model, and come back in and give us subsidy rates for the inputs I just put in, or at least it should.

Okay, the subsidy rates -- I don't know if you can read them -- are 4.92 percent for 1996, 15.92 for the next year, 18.98 for the third year, and 4.92 percent for the fourth.
And to tell you how easy it would be, as Tom mentioned at the beginning of the show, this was handy for analyzing what changes you could make to the program and seeing what the effects would be. To give you an example of how fast you can analyze a change, I can just type in a totally different program type, which is a guaranteed loan now, and the percent guaranteed is 95 percent. And you just tell it to run the subsidy rate again. This one didn't work last night at home. It looks fine this time. The first year didn't change too much. It is still about four percent. As a matter of fact, all the years now are around five percent. So what used to be 15 is now five.

To give you an idea of how much time this saved, when I first moved into farm credit it would take about 20 minutes for a simple change and probably about 2 hours to run an entire program over again. We recently were asked to do a sensitivity analysis on
what some of these assumptions would do to the cost of the programs. To save time, I just made another macro inside the spreadsheets and had them loop and let it run for about a week. In a week's time, I had about 200,000 individual estimates. So it really saves a lot of time. That is the conclusion of this presentation.

MODERATOR STANTON: Thank you very much, Chris. As Chris pointed out, this has two purposes. One, it enables those of you who work with subsidy calculations to calculate your own subsidy estimates on your programs. Second, for people like me that like to look at some of the trade-offs, what you can do is go in and assume that you want, for example, somewhat tighter scoring on your borrowers. You want a somewhat more credit-worthy borrower mix. If your program allows you to do this, then suddenly you can see the trade-off and your ability to serve that many more people with the limited funds that you might be appropriated in any given year. So the tool is a nice one, both for those people who have to calculate every year for federal budget purposes and for policy types who want to look at policy trade-offs. So thank you, Chris.

For the overseas audience and those who are getting downlinked in the United States, we will have a question and answer session after our next two speakers. Please telephone in at 1-888-924-3246. It is not an easy number to remember, and it will be flashed across your screens so that you can call in. What we will do is alternate, if there are people who do call in, between questioners here in the room and those who want to participate.

Our next speaker is Peter Zorn from Freddie Mac, Director of Policy Studies. Freddie Mac has an absolutely awesome application of credit scoring models. It gives us a vision of what you can do in terms of managing a credit portfolio if you have sufficient information and if you can control the essential information and understand the essential information that is embedded in your loan portfolios.

MR. ZORN: Well, if you could see that, it would say automated underwriting. Freddie Mac first offered Loan Prospector to our customers in January of 1995. It is now being used by about 300 of our sellers or originators and accounts for about 10 to 15 percent of our business currently. By the end of the year, we expect that to be about 20 percent of our flow. Within two years, we expect to do 80 percent of our business through Loan Prospector.

What I want to do here is a brief overview of the characteristics of Loan Prospector, what differentiates it from typical traditional loan assessment methods, and then some of the benefits that go along with it. The role of Loan Prospector I think is pretty straightforward, but it bears repeating. It is an underwriting tool, and the importance of underwriting for the mortgage finance system is really critical. I guess there are two key components that we see here. First is that it helps families buy homes that they can afford and keep, with the emphasis being on keep, in the sense that it also reduces the number of foreclosures and defaults. Those foreclosures and defaults are bad for everyone. They are bad for us because we, of course, guarantee the loans. They are bad for borrowers because of the implications of having to move and the cost of the blemish on their credit record and they are bad for the neighborhoods.

What Loan Prospector does is dramatically improve the underwriting process by more accurately assessing risk. The implications for us are two-fold. First, we can identify borrowers who would not previously qualify for a mortgage but now can. And secondly, we can identify some borrowers who previously did qualify for a mortgage but are higher risks than we would prefer to have.

The next slide illustrates sort of the broad basis of underwriting. The Loan Prospector uses the same information basically that all underwriters use, and the typical topology of the three C's of mortgage underwriting. Here is a little graph that you probably can't see at all that explains sort of what the idea here is. There are three basic features to the three C's or the characteristics that underwriters look at when underwriting a loan -- collateral, credit reputation, and capacity. The collateral being the value of the property and the applicant's equity in that property. The credit reputation measuring the borrower's past performance in paying off their debts as well as their current credit lines. And the third being capacity, which measures the borrowers financial ability to support mortgage payments.

The process of incorporating all of this information is very difficult. There are lots of characteristics here. I have just labeled some of the characteristics in each of these categories. As an underwriter, you are required to make trade-offs across each category, within each category, and that can be difficult to do on a consistent and objective basis. That is one of the characteristics that makes Loan Prospector so much different.

So what are those? I guess the first point here is that it is a statistical model based on millions of loans. So it has got the right objective function in the sense that it is ranking relative to performance of similar loans. The other ability is that because it is a statistical model and a computer model, it has got the ability to analyze simultaneously many, many, many factors and accurately assess the impacts of each individually or together. One of the characteristics that underwriters are aware of that are hard to incorporate in a consistent way is, for example, the layering of risk where you have multiple risk factors and it is difficult to consistently assess the impact of each of those on the risk of making a loan, or to accurately assess a compensating factor.

For example, someone might be making a large downpayment but have shown previous bad experiences, that is, they have been 90 days delinquent on loans in the past and have high ratios so that much of their income is going to pay off their mortgage payment. The question is, how to weigh those various factors. This is an area in which Loan Prospector is particularly good. The result is that you get accurate and consistent estimates that do a great job and a much better job at identifying loans that will perform and those that won't.

The next slide shows roughly how well Loan Prospector does in categorizing loans in terms of performance. The data that we have got here are approximately a million loans for single family units, unseasoned purchases from our 1994 fundings. What we did is we went back and we did an emulation where we acted as if these loans had been purchased through Loan Prospector and we came up with a Loan Prospector score. We ranked them and then we looked at their performance since that time. This is what these data show. In each instance -- for example, each bar shows for a closure rate relative to the average for a closure rate for the entire one million loans.

So we have three basic classifications. Loan Prospector comes up internally with a probability of going into default, but we put them into three basic buckets. The "accept loans," which would be on the far left, are those with the lowest projected risk, and they are automatically eligible for purchase by Freddie Mac. There are also certain benefits if you are an accept loan. There are reduced requirements for our originators. The "refer" and "caution" loans are also eligible for sale to Freddie Mac, but they are returned to the lender for a second look. The loans rated "caution" have the highest projected risk. You can see for example they reach foreclosure in these data at roughly 12 times the average rate of all loans, or if you compare them to the accepts, at about 32 times the rate of those classified as accept.

So what this is is a nice, consistent, and accurate way of assessing the characteristics of loans. The next slide addresses, as was brought up earlier in the earlier session, some concerns about fair lending issues. People have expressed concern that automated underwriting systems are developed for a population at large and they might not be able to capture the special circumstances of individual groups. This is clearly not the case for Loan Prospector. Probably the best evidence we think is to just show you how well they have predicted for various subgroups of our portfolio.

So, again, this is the same exercise. These are 1994 fundings. We went back and did an emulation and scored them as we would score them today and looked at their ultimate performance. What I am trying to bring away from these data here is that in every instance, whether the borrower is African American, Hispanic, or white, you see a significant difference in performance by how they were classified, that is, those classified accept performed far better than those classified as caution for all three groups.

The next slide shows the same thing with respect to income. This is income as a percentage of a area median. The area is -- well, you probably don't care. It was census tracked to the local level. If you are outside of MSA, it is counties. So again we see the same story here. Consistently, the Loan Prospector performed very well at separating the bad performers from the good performers. So one of the things is what is Loan Prospector doing for us? It is improving the underwriting process. We also argue that it provides benefits to consumers in the process of doing that. First, it improves the process generally. It does that in two ways. First, it decreases the time to approval. With Loan Prospector, typically you will get a response in under four minutes as opposed to days. So that if you are sitting as a customer at an originators desk and they type in the information and push a button, four minutes later they will know whether Freddie Mac will purchase the loan. They will get an accept or a caution rating back. And on the basis of that, they could approve the loan. That is the substantial difference in time.

The second aspect and benefit of the Loan Prospector in terms of improving the process is that it levels the playing field. Here what I am referring to is the fact that it is a fair and objective system so that every individual borrower is treated consistently and fairly. The result of all that is that there is also reduced cost. We estimate that the savings to borrowers on the savings in closing costs if Loan Prospector or an equivalent automated underwriting system were adopted throughout the mortgage finance industry would save on the order of about 2 billion dollars in closing costs each year. That comes from an estimate of approximate -- from our originators, we are seeing savings on the order of \$300.00 to \$650.00 per loan. So this is based on an estimate of about \$400.00 per loan savings.

The other aspect of savings is that what Loan Prospector does, of course, is identifies people who would qualify for conventional loans but don't under the traditional underwriting system. In the case, for example, of subprime borrowers, there are people who are in the subprime market but would qualify for a conventional loan. They are paying higher interest rates because of that. They are viewed as being riskier although Loan Prospector doesn't view them that way. The savings to them would be substantial if they were to obtain conventional mortgages instead of the subprime mortgages. The lower interest rates would be a savings in the order of 100 million dollars a year in interest payments.

The other benefit that we see in automated underwriting systems in general and Loan Prospector in particular is the ability to expand home ownership. One of the key aspects of loan prospector and automated underwriting in general is that it comes up with a more accurate and precise measure of risk which allows lenders to extend their ability to offer mortgages with a lot more comfort. We argue that that will ultimately significantly expand home ownership. We are estimating roughly on the order of about three quarter of a million new first time home owners.

That comes from really -- I think it is worth noting. Obviously Loan Prospector or any automated underwriting system is going to do two things. It is going to identify people that we wish we had given loans to who we are not currently and people who we are currently giving loans to and we wish we weren't. And those people, of course, will in the future under automated underwriting systems be not given those loans, the latter group, but there will be more of the former, that is, on net there will be an increase in the number of people who obtain loans.

That increase really comes from three basic areas. First, by reducing the closing costs, it allows a number of people for whom wealth is a significant constraint to get into the market. We estimate that on the order of about 70,000 families. The second thing is the leveling of the playing field. By offering a sort of fair and non-discriminatory system, it should, one, reduce discrimination, and secondly, reduce the perceptions of discrimination.

There have been lots of estimates about -- widely varying estimates -- about the impact of all that in terms of differential home ownership rates between whites and blacks and what percent of that is due to actual discrimination and perceptions of discrimination. It can range as high as 3 million estimates to as low as 500,000 or 600,000. We picked 400,000 as a number. It seems like a reasonable one.

The other group are applicants who would be denied loans under traditional underwriting systems, they would be given loans under automated underwriting. That is also a group that we are estimating on the order of about 250,000 families.

One of the interesting aspects of this and important aspects of this from a public policy perspective is that these individual families are largely going to be low income and minority families. Eighty percent of them will be low income and minority. Finally, the last slide is Freddie Mac is sort of committed to automated underwriting in a big way and to seeing that some of these benefits that we have outlined here actually come to fruition. One way we intend to do that, obviously, is by incorporating any enhancements into future versions of automated underwriting, our Loan Prospector. We are currently also exploring the possibilities of bringing some of the benefits of automated underwriting to new markets. One vehicle for doing that is the subprime pilot that we are doing with Standard & Poor's. A second is a FHA pilot with HUD which was talked about earlier. We are also working to broaden the way that automated underwriting can be used, not just for underwriting per se, but we are exploring the possibility of using it to target the scarce resources of home ownership counseling agencies to do a triage essentially about who gets the home ownership counseling. And finally to tailor servicing initiatives for borrowers once they have loans.

MODERATOR STANTON: Thanks very much, Peter. I find that presentation really impressive in a number of ways. First of all, it has been a lesson of a lot of federal credit agencies that if we end up giving a whole bunch of loans to farmers or students or homebuyers who can't handle the credit, we end up doing a lot of damage to the people we are trying to help. And what mastery of this portfolio information does for Freddie Mac is, as Peter said, first of all it allows them to extend credit to people that didn't look like they could handle it but who are eligible. But secondly, it allows you early in the game to deny credit to people who you might have thought could handle it but in fact who are going to cause defaults which hurt the taxpayers and also defaults that hurt the borrowers themselves. And then, of course, the refinements that you can figure out early in the game if you want to take a chance with somebody that may need special counseling or special servicing or a special form of intervention. And as Peter says, target your scarce resources then to that marginal category of borrower to help them over the hump. I think that is a really impressive presentation, and thank you.

Our third and final presenter before we move to questions and answers, and again the more interchange the better -- that is what this whole thing is about -- is Arnie Rosenthal, Assistant Administrator for Borrower and Lender Servicing at the Small Business Administration. He will be talking to us about servicing SBA commercial and disaster assistance loans and some of the benefits from consolidation, another driver of technology. By consolidating, you in fact may be able to serve your borrowers better using less staff resources at a time when a lot of agencies are coming under Congressional constraint. Arnie?

MR. ROSENTHAL: I always appreciate the opportunity to get before a group and talk a little bit about the servicing centers and some of the successes that we have had over a fairly sustained period of time. Our current portfolio as it now exists is roughly 460,000 loans valued at 34.6 billion dollars. In 1984, we had a portfolio that was roughly 400,000 loans and 16.1 billion dollars. I am going to talk quite a bit about currency rates for a few minutes. In 1984, our currency rate for our entire portfolio was 74 percent. Today, our currency rate for our entire portfolio is at 89 percent. So obviously a fairly good increase in our currency rate.

In 1984, we established the existing four disaster home loan centers that we currently have. We have one in New York, one in Birmingham, one in El Paso, and one in Santa Anna. Between the four of them, they currently have 183,000 loans that they are servicing on a day-to-day basis, representing roughly 3 billion dollars in assets. Just for disaster home loans in 1984, the currency rate was 75 percent. Two years later, by 1986, after we had established these four home loan centers, our currency rate had gone up or improved to 88 percent. Our currency rate today for the entire disaster home loan portfolio is 91 percent. And for those that are in the servicing center, our currency rate is 93 percent.

We went along for quite a while and determined that the home loan servicing centers were very successful. So we thought, why not commercial loans. We can do exactly the same thing for commercial loans. So in 1988, we piloted our first commercial center and that was in Fresno. In 1990, we expanded to include all of the loans in region 9, which is our San Francisco region, and then we further expanded in 1994 to include all of our Seattle region. In 1995, we transferred a few more offices. Today in Fresno, we have over 71,000 loans valued at 9.1 billion dollars. We are still in the process of transferring some of these portfolios from our district offices, and we are anticipating in 1997 to transfer 19 offices with approximately 44,000 loans.

In May of 1995, we expanded to a second commercial center in Little Rock, Arkansas. And within one year, we transferred 33 office's portfolios representing almost 65,000 loans. We still have in Little Rock, 11 offices that we need to transfer there, roughly 25,000 loans. Our currency rate in Fresno is now at 96.6 percent, and our currency rate in Little Rock is at 95.1 percent. Some of the advantages of centralization is that we have enhanced computerization and technology. We have more on-line systems. We are looking all the time for improving internal systems. We have a number of internal forms that we use to help increase the speed of decision making. Rapid contact -- we have a delinquent loan collection system where we call the borrowers after 10 days delinquent -- we get this in a queue each week from our computer system and we start dialing up the borrowers as quickly as we can. It is all in the computer and we keep notes on every contact that we make or lack of contact that we make.

We also have Autodial. Autodial will be a new system that we will be using in all six of our offices shortly. We have piloted it in Birmingham and have determined that it increased productivity by about 300 percent as a result of Autodial. We also are looking at interactive voice response, which is actually on-line right now. It is where a borrower can call up and get any kind of information they may require on their loan. They can get up to the last five payments. They can get interest paid. They can establish a pre-authorized debit if they wish. They can even get an account summary faxed to them if they want it.

Another center advantage is that it is a more controlled portfolio with uniformity of actions. We have had some concerns among some of our lenders that they deal with different district offices and get different types of credit decisions. Consistency in credit decisions is very important. We have established a format book for both of our commercial centers and we have one also for the home loan centers. If anyone is interested in this, we can certainly make it available to you.

One of the other center advantages is better servicing to our lender partners. We feel again through this consistency that we can work with the lender more appropriately than a bunch of district offices and we can also improve our turnaround time in our actions. We currently have a goal where all servicing actions need to be accomplished within three days. Another center advantage is that we have better portfolio performance. Again, on the currency rates, I indicated earlier that the currency rates have gone up dramatically. That results in improved debt collection. We also have early warning systems to help notify us of any delinquency problems, and we work together, again, with the individual lenders.

Specialization of functions and greater expertise in particular areas; we have the ability to work only on servicing. Currently in our district offices, they have a multitude of responsibilities and are not quite as focused in a lot of respects on just servicing. So within our servicing centers, we focus just on servicing issues. Intensive servicing units will be established in each of our centers and we are looking forward to doing that, working with the individual loans and trying to provide as much workout as we possibly can in order to reduce any further liquidation effort that may result.

Another big benefit is reduced staff. As we have been downsizing or right-sizing, we have obviously lost a number of people within the agency and we have been able to absorb a lot of that as a result of transferring these portfolios to the centers. We also achieve economies of scale. As a result of our centers, we are now able to process two to three times the number of loans per person that were previously serviced. We are constantly looking at state-of-the-art automation. We are looking at all technologies. We are looking at paperless systems. We are looking at our Low Doc Program going paperless and keeping that within the servicing centers and moving towards a paperless system at some point in time in the future. We are looking at E-mail services through the Internet, and we also do quite a bit of electronic funds transfer.

Some of the things that we do as outlined again in this format booklet is we do any kind and all kinds of servicing actions to the loan. That could be dealing with the collateral in terms of a subordination or release or a substitution. It could be working with the individual borrower to try and work out a problem that they may have and we may provide a deferment to them. Assumptions, guarantor changes, payment modifications -- there are a number of things that they do. I won't go into all of them.

As a full-service servicing center, we also have our own in-house legal support. A number of the offices that we deal with deal with different states, a multi-state environment. So we have lawyers that are familiar with each of the state's rules and regulations and laws. They do state filing requirements to assure that all rules and regulations are adhered to. They do all the paid-in-full processing to assure that SBA has released all collateral and methods required by the various states. They verify the validity and completeness of all legal documents for loans, and they assure that all state and federal documents and requirements are met.

As a result of our efforts in consolidating these servicing centers, like I said, we have been able to reduce employment fairly dramatically over the last number of years. Our agency at one point in time had roughly 4,600 full-time employees, and we are now down to about 3,000 employees, and a lot of it has been through the efforts of centralization.

MODERATOR STANTON: Thank you very much, Arnie. I think I will stay here for the questions and answers. I guess what I heard from there that I hadn't heard in our initial interviews with you, Arnie, was not only the savings in FTE but the fact that when you centralize your servicing, you manage to get a much more manageable managerial unit. For example, what you talked about in being able to have the lawyers right there to deal on a multi-state basis with the loans that you are worried about. That you can in fact do a lot more through a centralized servicing center than you may be able to do through a whole network of servicers.

MR. ROSENTHAL: As part of debt collection improvement, we certainly are looking forward to possibly being available to servicing other portfolios for other agencies. Kind of a plug for that.

MODERATOR STANTON: So if any of you are looking for a seasoned servicer, call SBA. Shall we now go again to interchange. We have heard a number of different options that may relate to your own programs. Do any people have questions before I ask some of my own in terms of Chris and credit subsidy modeling, or Peter and credit scoring, or Arnie and centralized servicing?

MODERATOR KESTERMAN: I have a question for Peter Zorn. The savings from using the automated underwriting, is that because you reduce fees or are there other savings? Where does that come from, the 2 billion dollars?

MR. ZORN: The 2 billion dollars? That is actually very simply an assumption that if automated underwriting were widespread throughout the mortgage finance industry and saved on average about $400.00 per loan in closing costs, and there were about the same number of mortgages originated as there were in 1995, which are 5 million, you can multiply the two together and get that.

MODERATOR KESTERMAN: Is that a reduction in the lenders' fees?

MR. ZORN: What we know at the moment is that lenders are saving on the order of $300.00 to $650.00 in originating the loans. That makes the assumption that the competitive pressures of the market will force much of that along. We said about $400.00.

MODERATOR STANTON: Other questions? Tom? Just a second. We have a microphone coming to you.

PARTICIPANT: Chris, on your model, just a couple of questions. On the ratings that you mentioned, have you had any experience with using any other rating system such as ISP or Gudes? Do you think this could be adapted to other rating systems?

MR. BURNER: At this time, we have had no other experience. In Farm Credit and Housing, we have tried to base the defaults on program personnel's expert opinion because we didn't have access to that data in our mainframe databases. And in the international programs so far, the ICRAS ratings are the only ones that we have used for any of the subsidy estimates.

PARTICIPANT: On the model, is there a function for prepayments?

MR. BURNER: On this particular one, there is not. Prepayments are actuals, and I don't have any inputs for any type of actuals at this time. That is a system I would like to get working. The part of the system that I would like to do is to take the actuals off the mainframes as they exist so that people don't have to reenter those as well.

MODERATOR STANTON: I guess, Peter, a couple of questions. You now have a pilot program with FHA?

MR. ZORN: Correct.

MODERATOR STANTON: And one of the issues that bedevils some federal programs is quality of information. Freddie -- for years I have talked to your financial types, and you have always had pretty robust models of what is in your portfolio that you were able to operate off of for purposes of Loan Prospector and then sort of getting predicted defaults and measuring your credit scores against it. I am wondering if you can tell us a little about your experience when you moved to pick up FHA and maybe also if you can talk a little about moving to pick up B&C lending, which is your subprime loans, and any thoughts in terms of quality of information and steps government agencies might take if they want to pick up on something like this for their own purposes.

MR. ZORN: I guess there are two forms of information that are needed. One is sort of the on -- once you have the system in place, the ongoing information, and that is not unique to anyone, that is, we all share the use of the credit repositories. There has been a fair amount of study of the validity and the value of those data, and I think it is pretty clear that they are well representative, et cetera. The more problematic problem is getting the data initially to essentially calibrate the model to individual loans in your portfolio. In our case, we were very familiar with our data. In the case of FHA, it was not too difficult for us to take their data. One of the problems is to go back in time and pull the credit repository information at the time loans were originated. That is expensive, but it is something that the credit repositories are happy to provide for a fee. And then it is just the quality of the information that the agencies record at origination and maintain. We were very comfortable with getting a large enough base from HUD/FHA that we could do that.

Our experience with the subprime market was similar. We got some of our sellers and we asked them to provide us with some of their subprime loans, a historical record for some of their subprime loans and essentially created a subprime card in that manner.

MODERATOR STANTON: How big was your data set that you needed on the subprime side? Or what is the smallest useful data set that you can use for something like subprime that has presumably quite a bit of variance in it? I am thinking in terms of government agencies maybe being able to go in and sample their own portfolios in order to after the fact do things like you did with your 1994 data.

MR. ZORN: Well, I guess I wouldn't want to speak too authoritatively on that. One of the benefits that we had is that we had ideas from our own experience. So we used millions of our loans to develop a model that we are then trying to recalibrate. But we came in with a fair amount of capital. We were using much smaller data sets for FHA and the subprime, more in the order of tens of thousands -- 10,000 to 20,000 loans there. But we had the advantage of basically knowing what we were looking for.

MODERATOR STANTON: One last question, if I may. You know, Texas -- if we have rolling recessions like we had in the 1980's, Texas goes in the tank. All of a sudden, somebody who was credit-worthy with a given score, when you look at that new variable, you might say, hey, we could end up with a lot more defaults than we originally anticipated. To what extent can you use your credit scoring system as a financial early warning system and sort of recalibrate the underwriting that you will accept for loans?

MR. ZORN: I guess the answer is that that is something that we are very interested in doing and exploring pretty aggressively, but not something at the moment that we are out in a production mode on. One of the things that it is interesting to -- there is an element to which you are asking how well can we predict the future on the basis of what we observe in borrowers today. There does seem to be some information and one of the experiences is that people tend to have difficulty in repaying their debt when they are in a poor economy and economies take a while to turn around. So if there is some experience where you see from certain areas that you are getting people with poor credit histories, that might be some indication that that would continue in the future. There is obviously a similar sort of relationship with house price appreciation, et cetera. And those are things which at the moment we do not have incorporated in our card. But there is widespread interest in all of those things, and we are certainly part of that group.

MODERATOR STANTON: Other questions? Yes.

PARTICIPANT: I have a question for Arnie on the centralized centers. First off, the loans that you have you mentioned are disaster loans and then some business loans also. Now I take it with the servicing centers, you are only servicing either direct SBA loans or those SBA guarantees that have defaulted and that is subsequently your purpose, is that right?

MR. ROSENTHAL: That is correct in the commercial centers. We rely on the banks very heavily to service their own loans. There is an interaction between the servicing center and the lender to make sure that it is done in accordance with whatever unilateral party they may have.

PARTICIPANT: So if the center is ultimately unsuccessful -- when we say servicing, we are talking about working out some loan arrangement so that the borrower again becomes current -- if that ultimately fails, what is the process there? Have you moved to centralize the liquidation centers?

MR. ROSENTHAL: We have -- in Santa Anna, where we have a disaster home loan center, we have also now incorporated a disaster home loan liquidation center. And we are handling the majority of the loans as a result of some of the disasters that have occurred out in California. We are handling it predominantly in the southern California area. It was a really good fit where any loan that the servicing center could not handle and it looked like it needed more intensive workout or actually was going to go into liquidation, it would then go into that liquidation center. We are in the process of establishing that right now and we have already transferred a number of loans from some of the surrounding district offices.

MODERATOR STANTON: Other questions? Yes?

PARTICIPANT: I would like to ask Mr. Zorn about what he found to be the principle expandatory variable with respect to his model. One of the things I noticed in your presentation was that income does not appear to be a significant -- income level is not a strong predictor whereas race appears to be a factor, particularly with respect to blacks and Hispanics. I was wondering if you could assess that on your model?

MR. ZORN: Yes, sure. I will first state right up front that race is obviously not a variable in our model. Second, that income -- I mean, one of the two sort of broad -- if you look at roughly the sort of three C's story there, the one being collateral, the second being credit reputation, and third being capacity -- one of the things that we found in our research that was somewhat interesting, we thought, and had one of the more obvious implications in terms of allowing us to accept more borrowers, is that the ratio -- the traditional front and back-end ratio, while predictive of loan performance are not nearly as predictive as we thought. So we are much more comfortable now going over the traditional guidelines in terms of front and back-end ratios than we were before.

MODERATOR STANTON: Can you explain front and back-end ratios?

MR. ZORN: Yes. The ratios we are talking about are total housing debt to income ratio, that would be the front-end ratio, or total debt to income ratio being the back-end ratio. So the usual sort of analysis that an underwriter will go through in underwriting a loan is ask the question, how much of your income on a monthly basis has to go to paying off your housing expenses and then how much in total has to go up to paying off all your debts. What we found is that there is nothing magical about that ratio. As you have to pay more and more of your income to debt, or to housing debt in particular, it is the case that you are more and more likely to have difficulties making payments and therefore going to foreclosure or default, but at not dramatically increasing rates. So that the increased risk that we bear or that the borrower bears of having a high debt to income ratio is not that great compared to a low one. So that is one of the variables that have traditionally been viewed as quite important but which was de-emphasized as a result of our analysis. And probably the ones that were, I guess, reconfirmed as being important were roughly the credit reputation -- your credit history variables and the details of all those as well as the importance of your downpayment or your loan to valuation.

PARTICIPANT: So the demographics are not significant? Is that what you are saying? Or not as important?

MR. ZORN: Well, we are prescribed by law not to look at them except to do analysis. They are not anything -- they have nothing whatsoever to do with an assessment of the credit risk. So it is the type -- we are looking at it because we are concerned about the impact of our model, which is why we presented the information. But it is not going to be used in the process of making an assessment of risk.

MODERATOR STANTON: There is one other question -- I think there is one other question. No, I saw a hand wave. Let me say to the television audience at this point that in two minutes we are going to be signing off the TV broadcast. Once again, we would like to thank the people from GSA who were able to put all of this together. We will be resuming the TV broadcast in our servicing panel this afternoon at 2:00. But for the rest of us, let us continue with questions and answers for probably another five minutes. So we thank all of you out there in TV land and hope you join us again.

PARTICIPANT: I have a question for Peter. In your model, is there anything that predicts when someone goes into default what the probability is that they might go to foreclosure or be financed with some other type of workout procedure?

MR. ZORN: I am not quite sure that I get the nature of your question, so let me just blather on and tell me if I hit what you are interested in. The way -- ultimately what we are interested in from our perspective is losses. So the severity or however you want to look at it, so from this perspective we are headed, the data that we used to develop our models is on the basis of what we internally call default or sometimes real estate owned. Those are properties which we actually own. So they went through foreclosure and we ended up holding ownership to those properties. So the data or the predictions are based on the probability that that event will occur. We have, in the process, looked at the various transitions from being 90 day delinquent to foreclosure, et cetera. So that is certainly part of that and that is part of the process that we have looked at.

To answer what I think is also another question, the issue of servicing and the extent to which -- if any of these loans do get into trouble, the extent to which we would want to develop workouts or foreclosure alternatives or modifications to the loan, we are actively involved at the moment in using not Loan Prospector per se but a similar technology built on Loan Prospector to look at those issues and try to use that tool to help us better allocate our resources toward picking people in our portfolio who would benefit from those forms of service.

MODERATOR STANTON: I have got one last question that I have got to ask you, Arnie, with your centralized servicing centers. And that is, how do you minimize possible adverse political reaction? For example, not to choose a particular case, but as you were talking about closing servicing operations in Little Rock, Arkansas, I sort of got this vision in my mind that it might not go as easily in some agencies as in others and I am just curious for those agencies that are contemplating centralizing servicing, what are steps you can take to sort of get everybody to understand how necessary it is for program management at a time of declining resources?

MR. ROSENTHAL: I think what we have done fairly successfully is that we have talked with our people up on the Hill and our committees and have shown them. You know, we have been in the centralized servicing business since 1984, so we actually got a headstart on a lot of people. And we have shown the savings and with the right sizing and the reductions in the budgets that have been taking place, we have been able to basically show the Hill that we, in fact, can improve our subsidy rate and improve what they are appropriating to us. So, our committees right now are in full support. As a matter of fact, in our last bill they have indicated that they want all the other offices transferred to the centers within 60 days.

MODERATOR STANTON: Well, thank you very much. There is one last question. Why don't we take it, please.

PARTICIPANT: This is for Peter Zorn. I was just curious in your risk classification, it looked like an awful few were accepted right out and a lot had to go back to the lender for a second look. How does that compare before the Loan Prospector, and do you foresee that to decrease as you use this model?

MR. ZORN: I am afraid you misinterpreted the data that I was presenting there. I never actually gave you the distributions of how they fell into each of those categories. It is roughly we are seeing in the Loan Prospector the through the door population on the order of about 60 percent or so of the loan applications are coming out as accept classifications. So it is only on the order of about 40 percent that would be to refer and caution. And the caution account for only under about 10 percent.

PARTICIPANT: And didn't you say something about 32 times greater or something?

MR. ZORN: Yes. That is the rate at which they go into foreclosure. So that is a performance measure as opposed to a distribution in the population.

MODERATOR STANTON: Any other last questions? Tom?

PARTICIPANT: Looking at your model, it seems that you have identified some factors or predictors of delinquency and default that would indicate that some of the criteria that we use inside of government, where we look (indiscernible). To some extent what you are finding is AGI for some of these programs is not predictable. But rather other factors. It would be interesting if you could apply that model to some of our portfolios to see what the impact would be there as well. Have you ever thought about doing something along those lines?

MR. ZORN: Well, I guess that is in some sense what we are doing with FHA, and we are more than willing -- in fact, we are eager to do it with anyone
at all who is interested in doing it in other markets. We very much think that automated underwriting is the wave of the future. So we have a missionary zeal. So we are more than willing to engage in that.

PARTICIPANT: Great. Thank you.

MODERATOR STANTON: I think that is a great note on which to wrap it up. We will be meeting again at 2:00. I know there were a number of people who got here very early this morning to hear John Koskinen. He will be here at 2:00 to make his presentation and then we will move right into the servicing panel which Frank will be hosting. I want to thank our panelists once again and thank all of you. I think we have had, again, a very good interchange. Thank you.

(Whereupon, at 12:35 p.m. off the record until 2:00 p.m.)

A-F-T-E-R-N-O-O-N S-E-S-S-I-O-N

2:00 p.m.

MODERATOR KESTERMAN: Good afternoon to our U.S. and international viewers. Welcome to the first government-wide Workshop on Promising Practices in Credit Management. This afternoon, we began our 3-day program with panels on loan origination, loan credit scoring, credit risk rating, and SBA's consolidated loan centers.

Before we begin our next panel, it is my honor and pleasure to introduce to you Mr. John Koskinen, Deputy Director For Management, Office of Management and Budget. Mr. Koskinen has held this position for the past two years following a distinguished career in the private sector where he specialized in asset management. He is also chairman of the Federal Credit Policy Working Group, one of the principle sponsor organizations supporting this conference. He is also known to many as Mr. Government Performance and Results Act. It is my pleasure to present Mr. John Koskinen.

MR. KOSKINEN: Thank you. I am delighted to join you this afternoon. I particularly appreciate being introduced as Mr. Government Performance and Results Act because last year at this time I became known as Mr. Shutdown, and I would like to tell you that it is a lot more fun to be involved in GPRA than it is in shutdowns. In fact, as somebody was reminding me, last year after the middle of the second shutdown, a little article appeared noting that one of my concerns was that my epitaph was going to say, "Shutdowns are shuts down", which seemed to me not necessarily the best way to be remembered.

So, I am happy to be here with you today on the first day of the fiscal year. I was in an event this morning with the Defense Department where we talked about performance and rolling out a performance-based organization at the commissary, and as John Hammer, the Comptroller of Defense said, everybody in the Federal Government is feeling good today because they all have cash. So with that in mind, it seems to me an appropriate way to start thinking about, as you all are now and will be in the next couple of days about how we handle the cash in a particularly important set of programs in terms of credit programs and credit management.

I would like to thank the Federal Credit Institute and the Federal Credit Policy Working Group for initiating this first-time effort of federal credit experts to validate and share a comprehensive program of promising credit management practices. This conference is focused on agencies showing and telling all of us in the federal credit management community what works. This discussion is especially timely in an age when the government is being challenged to work a lot better and cost a lot less.

Even in an age of downsizing, the taxpayer expects higher performance at all levels of government, federal, state, and local. Just yesterday, as part of the continuing resolution, the Congress passed a bill to insure that federal financial management improvements are implemented. And as we move forward, I think we will continually have to focus on the fact that we live in an age when customers and the taxpayers need to come first. Today, borrowers from our various agencies and credit programs expect to be treated like customers. In the private sector, customers are often asked over and over, did you get what you bought? Are you satisfied with our work? If not, why not? What can we do to improve our service?

Therefore, I think -- and as I look at the agenda of the various promising practices, I think it is appropriate that a number of them focus on how we can serve our clients better. The Federal Government continues to be the nation's largest source of credit. In 1995, the Federal Government disbursed 19 billion dollars in new direct loans and guaranteed 123 billion dollars in non-federal lending. As of the end of fiscal 1995, total federal credit assistance outstanding was 942 billion dollars. As Everett Dirksen was once quoted as say, "At that level, you are into real money."

Federal credit assistance is extended for a variety of policy reasons. A national purpose is served in extending credit to eligible individuals in certain groups such as students, veterans, farmers, first-time home owners, and small businesses. A natural consequence of these policy decisions is that the Federal Government understand it may experience a higher default risk for its borrowing than the commercial sector.

Therefore, in order to meet the challenges we confront, this conference includes 38 ideas that have been tested and practiced in at least one agency. Frank Kesterman from the Treasury Department and Tom Stanton, our consultant, did the legwork to identify and select these promising practices for presentation, and they deserve our heartfelt thanks for a job well done.

These 38 examples were selected from twice that many innovations that were studied. The key standard for selecting the practices being presented in this conference is that the practice is cost effective and has been implemented. It must be a real thing, not just somebody's interesting idea or suggestion.

In reviewing these practices, Frank and Tom found that the pace of innovation and improvement can be fast. And you have begun to hear about that and you will over the next two and a half days. It is reassuring because despite the image of the Federal Government as often being slow or inert, we have found the credit agencies are open to change and they are changing when they see a practice that is really working.

These promising practices are important for us to share because the Federal Government must be more aggressive in working to improve its management of each step in the credit program process. These steps obviously include the design of programs to meet their objectives and to avoid unnecessary losses, credit extension, account servicing, special collections and asset sales, and program evaluation.

We have a three-part strategy to insure cost effective management of credit programs. First, we focus on reengineering agency programs and operations to reduce risk and losses. Examples that are included in this three-day seminar include the credit alert system that screens loan applicants for prior defaults, also known as the CAIVRS system, the Department of Education's management of the New Direct Student Loan Program, and the Small Business Administration's use of three tiers of lenders based on performance.

Second, the focus is on improving agencies' capacity to manage loan portfolios effectively and efficiently. Examples presented include Ginnie Mae's issuer portfolio tracking system known as IPADS. What would a program be without an acronym. And Ginnie Mae and the VA and the Federal Housing Administration's use of the correspondent portfolio analysis database system, which is also a performance tracking system of participating lenders. Another promising practice in this area is the Education Department's tracking of the financial responsibility of participating educational institutions and the use of the early warning systems by the Federal Reserve and the Pension Benefit Guarantee Corporation.

A third focus is enhancing customer service. Some examples in the program include special servicing by the Veteran's Administration for troubled borrowers who demonstrate they can move from default to payment status. Expedited premium refunds by the Federal Housing Administration and the inner voice access for borrowers about their loan status developed by the Small Business Administration.

We also serve our customers well when we make efforts to reduce the incidents of delinquency. Recently, the Debt Collection Improvement Act of 1996 was enacted to give agencies new tools to collect delinquent debt, such as the new Treasury Intercept Authority to offset federal payments for seriously delinquent debts. This conference focuses on tools which should be brought to bear before special collections on defaulted debtor occur. The complimentary purpose of this conference is to showcase tools that will serve our borrowers and protect the taxpayer against unnecessary losses. This is as good a point as any to mention that the Debt Collection Improvement Act gives agencies a new incentive to improve collections by providing for gain sharing. The agencies that increase annual collections over their baseline can use up to 5 percent of the increase to finance credit management improvements. The promising practices presented at this conference should help you in developing your list of gain sharing investment opportunities.

At this point, I would like to note that this Act and this provision in the Act came about through the work of all of the agencies represented here through the vehicle of the Federal Credit Policy Working Group, which for some time had focused not only on improving debt collection but on the need to provide additional resources to that activity. As was noted, and as you all know far better than I, all too often -- not all too often -- inevitably in the past, when debt collections went up and were improved, while that was good for the government overall and it was important for improving the subsidy rate calculations for a program, the actual funds went directly to the Treasury and there was no way for an agency to provide more resources to increase the amount of debt that was collected. Therefore, I think this provision in the Debt Collection Act is a watershed provision designed to allow agencies that are effective to continue to provide resources to increase that effectiveness.

As noted, the Government Performance and Results Act places new management expectations and requirements on federal agencies by creating a framework for more effective planning, budgeting, program evaluation, and fiscal accountability for federal programs. One of the things we have talked about in the Federal Credit Policy Working Group is as we move forward in the effort to define not only the mission of agencies and of programs, but our goals and our performance measures, it is critical that we develop those performance measures out of the information that managers, when they are doing their work well, use to manage their programs.

The Federal Credit Policy Working Group and its agencies have been at work for over a year looking at each individual program and trying to come to consensus as to what are the appropriate measures for not only good management but effective performance in those programs. And as we have looked at that, we have discovered a range again of promising practices that are important to look at. There is HUD's partially assisted multi-family sales program that permits properties to serve their low income purposes but be managed by private parties.

We also are learning somewhat belatedly the lessons from the Resolution Trust Corporation and all of its experiences, not only in equity partnerships and joint ventures but asset sales. And again, I would note that one of the great untold success stories in the last several years in the government is the success that the Resolution Trust Corporation had in working its way through what was at that time really the largest management challenge in the history of the government. How to deal with over 500 billion dollars of troubled assets.

We also have a practice that is emerging that many of the agencies are now participating in and that the Federal Credit Policy Working Group is supporting, which is the Government-Owned Real Estate program, also known as the G.O.R.E. program. Not for political purposes, but that is the acronym that works out when you say Government-Owned Real Estate. The GSA is working on it and it is included in the conference program. But as I noted, what we need to do is we build on these practices and as we focus on the measures that we are going to use to respond to GPRA, our real goal is to focus on measures that will allow you to respond to better management of the credit programs directly and better service and effectiveness for the customers.

Recently, the Federal Credit Policy Working Group as part of its process conducted a survey on the agency's use of outcome and output measures. In general, the responding agencies said that many of the proposed categories that were listed by the task force of the Federal Credit Policy Working Group were applicable to their programs. A couple of interesting examples, nine of the programs wanted to measure whether their borrowers were pleased with the timeliness and quality of their services. The same number wanted to asses whether they reached underserved populations or neighborhoods.

There is a lot of very important work to be done. We need to identify and implement promising practices if we are going to meet the challenge of the government to work better, cost less, and satisfy both its customers and the taxpayer. The Federal Credit Reform Act, the Debt Collection Improvement Act, the Federal Financial Management Improvement Act, and the Government Performance and Results Act all form, when viewed together, a mandate to improve government performance and effectiveness and thereby restore the confidence of the public in federal programs.

One of the things that is clear is that the increasing suspicion on the part of the public about the validity and viability of federal programs relates to the fact that we have lost touch with the public in terms of explaining both the mission of the programs that we manage and also the effectiveness of those programs. Ultimately, all taxpayers ask really is to know what are they getting for what they are paying? And that is one of the issues that we are focused on in an general manner in the Government Performance Results Act, and clearly in the credit programs. One of the things we have talked about is we need to have and generate better understanding in the private sector and in the public at large about not only the purposes of the various credit programs but their cost, the efficiency, the customer service improvements that we are making, and the overall management competence that we have as we deal with these programs and the public. Ultimately, these programs touch tens of millions of Americans. And if we can demonstrate not only that these programs are effective, but deal effectively with the beneficiaries of these programs, I think it will be not only to the benefit of these programs, but will result in an increased awareness on the part of the public as to why these programs exist in the first place.

This conference and the promising practices that have been identified, therefore, can make a real difference in how we serve the public, both borrower, customer, and taxpayers. And I invite you to consider the ideas offered here, and I hope that after the conference, you and your agencies will join me in challenging not only your own agency but the Federal Credit Policy Working Group and the Federal Credit Institute, challenging them to choose five of the promising practices as possible government-wide or agency special initiatives where an investment of time and resources can have a real payoff to the taxpayers and our customers.

I genuinely appreciate all the time that has gone into this conference, but more significantly and importantly appreciate the time and interest and enthusiasm that we have found throughout each of the agency's programs in these initiatives, designed as I say to determine how we can make the programs work better, not only for us and for our customers. And as we go forward, we at OMB and at the Federal Credit Policy Working Group are available and will continue to provide whatever support we can as we all jointly move forward together into the days ahead.

On that basis, I would like to wish you good luck, not only in the next two or three days, but in the next several months and years as we work on these problems together. Thank you very much.

MODERATOR KESTERMAN: Thank you, Mr. Koskinen, for a very important message. Thank you for being here. Our next panel is a panel on lender monitoring. The first speaker will be Chris Greer, Deputy Assistant Secretary for Multi-Family Housing joined by Jack Kerry, President of the Kerry Company.

MR. GREER: Thank you, Frank. Good afternoon, everybody. It is a pleasure to be here to begin sharing best practices. We are very proud of the SWAT program at HUD. SWAT stands for Special Workout Assistance Teams. We don't have a whole lot of time, so what we thought we would do to get the information to everyone is use three techniques.

Number one, we have a handout. I hope that you folks have one, and if you don't that you will pick one up after the session is over. Number two, we are going to show a video that can tell us about the SWAT program in general in a way that is different and far better than someone sitting here preaching to you. And the third thing I want to do is put stuff in context.

John mentioned that the Federal Government has about 940 billion dollars worth of insurance in force. FHA being one of the largest, if not the largest insurance company in the world, has between 40 and 50 percent of that. In other words, we have somewhere between 400 and 500 billion dollars worth of insurance in force. Parker Deal to my right will be talking in a few minutes about the Single Family Program. My responsibilities deal with the multi-family program.

On page 11 of this handout, there is a triangle which depicts what we are dealing with at the HUD multi-family. We are dealing with a 47 billion dollar portfolio of insured mortgages, that is, insured and HUD-held. About 7 billion dollars worth of that is HUD-held mortgages. We have about 15,800 properties. About 2,000 of those deal with health-related facilities. For example, we insure hospitals, we insure nursing homes, we insure assisted living facilities. So those are health-related. The remaining 13,800 or so are rental housing.

It has been estimated off and on that about 20 percent of our portfolio is in trouble at any given time. When I say in trouble, I mean financially or physically, and that is what the SWAT program was designed to do. It was designed to help train our field staff in getting the capacity to deal with troubled real estate. It was designed to help analyze data so that we would detect and then take action on problem projects. And thirdly, I wanted to mention that we are very proud of the fact that Vice President Gore has seen fit to award a Hammer Award to this SWAT program.

So if you look at your chart in going down this a little bit, one of the things that John just mentioned was note sales. HUD has been a very active player recently in note sales and have sold upwards of 3 billion dollars worth of notes, getting back close to 80 cents on the dollar. And that is one way we are dealing with our HUD-held portfolio.

So basically that is what I wanted to do is simply give you the context that we are dealing with about 40 billion dollars worth of mortgages here and 20 percent of those are in trouble. And the SWAT video will explain how we deal with that 20 percent. If you could run the video now, I would appreciate it.

(Video plays at this time.)

MR. GREER: And there you have the video. We could spend a day or so talking about how we got to this place in history, but we don't have the time for that obviously. We are going to move the agenda along. All I would like to do at this point is introduce Jack Kerry. He is the founder and president of the Kerry Company. He is the owner of several properties and a manager of properties. Not like the ones you saw with the rats and roaches, but rather the marvelous communities that you saw in some other shots there. Jack has lent us his expertise through contracting. Our capacity at HUD is dwindling like every other agency, so we have reached out and used contractors to a large extent. Again, getting to one of the points that John Koskinen was making about reengineering the way we do our business. We will be around to answer questions later, and I commend this document to you to get into more details and if you have questions, you can always call us. Thank you very much.

MODERATOR KESTERMAN: Thank you, Chris. That was a real example of taking a world class problem head on. Congratulations to you. Our next speaker is Parker Deal, who is Director of Quality Assurance at FHA, U.S. Department of Housing and Urban Development. His subject is lender surveillance, quantitative and qualitative methods. This is a mixed panel of borrower surveillance and lender surveillance. You have probably figured that out by now.

MR. DEAL: Thanks, Frank. Actually, I am subbing for somebody who was subbing for somebody, and I got the message this morning, so bear with me. Bill Hayman, my boss, could not make it today. He had a fairly flimsy excuse. He retired effective today. So we all wish him well.

What I thought we would go over today is basically what single family FHA is doing to manage its risk. In the last few years at FHA, we have really streamlined our operation. We had to, as we all know, because of potential cutbacks and future cutbacks. And what we have done is turned a lot of our responsibilities over to the industry. It is now easier, for example, to become an FHA approved lender. Many of the steps that we used to take in-house in approving loans and issuing mortgage insurance certificates are now being turned over to the industry to do, so we are going to be monitoring those activities.

In fact, the latest activity that we are going to be turning over soon and some new legislation deals with that last step that I mentioned. Lenders will now be able to issue their own insurance endorsement certificates. We have been doing it for 62 years at FHA, so now we are going to turn that over to the industry.

Thus, when you have this kind of a streamlining effect, the department is concerned that we enhance our monitoring capabilities to keep close look. The three things I am going to talk about will be the quantitative part of our monitoring and an agreement that Nick Retsinas, our FHA Commissioner, signed last week. I guess you can't see that too well, can you. Turn the lights down. The first part deals with the quantitative part of my presentation, and it is basically weighing the risk. What we have done, and this took a while to put together, is develop a system that we can measure a lenders performance and take appropriate action. The system or the acronym that we use is MPAS, which stands for the Mortgagee Performance Analysis System, I believe. I want to thank the Treasury and Frank Kesterman for footing the bill for that. I guess that was about a million dollars, wasn't it, Frank? Or at least. That is about right -- whatever. I want to let you know that my division is doing car washes and bake sales and we are going to pay all that money back to the Treasury. The checks are in the mail.

Let me tell you what this system is all about. As background, let me start out by saying that my division, the Quality Assurance Division at FHA, is the entity that goes out on site to lenders' offices and performs what we call monitoring reviews. It is sort of a miniaturized version of an IG audit/investigation.

Let's suppose we do those reviews and we don't come up with a lot of serious or significant findings, but yet that lender has an awfully high default rate. In the past, we were limited as to what we could do obviously because of due process. If you approve a lender, there is due process before you take that approval away. What this gives us, this new system or this MPAS system, is a way to measure a lender's performance and make a determination of whether we want to continue to do business with them strictly on a contractual basis.

And what we mean by that is let's suppose, again, that we don't have based on our monitoring reviews a lot of information to warrant a withdrawal of a lender's approval. We will look at the lender's performance on a quarterly basis focusing on what we call early payment defaults and claims, measuring that lender's performance against other lenders in a similar area. So we really are measuring apples against apples. If we find that a lender in a certain geographical area has a default rate that is double that of other lenders in that area, we then have the option to start what I call a termination process where we will contact that lender and basically tell them, look, your default rate is too high. We are considering taking your approval away. You have 30 days in which to respond.

This program is brand new. We have just started it in the last few months -- three or four months I suppose. We have terminated several lenders so far and there will be some other ones that will be getting some letters soon. If that default rate is not double what it is for other lenders in that area, but let's say it is one and a half times that high, then we will put those lenders on what we call a close watch list and we will watch that performance very carefully, notifying those lenders that you've got to get that default rate down and if you don't, you could be in harm's way.

The important thing, again, with this MPAS system is that we are comparing apples against apples. We are not going to penalize a lender who is doing business in an area of the country that has a high default rate already. We want to make sure that we only take this action against those lenders who really are creating an undue risk to HUD and we just don't want to do business with them anymore. That is what I mentioned before about that credit watch list that we will put lenders on and review their performance on a quarterly basis.

The next part, if we are ready for that one, deals with what I call the on-site monitoring of FHA, most of which is done by the division I represent, the Quality Assurance Division. Our purpose is quite obvious. We go on site for a week or two and we review a lender's performance to make sure they are performing in accordance with our requirements. Are they following our rules? The way we are set up is different than in some areas. It is a headquarters-based function, meaning that the Quality Assurance Division is housed out of Washington, D.C., but virtually all the staff are outstationed in various HUD offices, and it is those out-station people that go on site and do these lender reviews, audits, or investigations, whatever you want to call them.

We will probably perform about 400 or so of these reviews annually. Additionally, the local HUD offices, and we have 81, look at recently closed loans at the HUD office. So we have a review of lenders' defaults on-site. We look at lenders' recent performance by each HUD office looking at recently closed loans, and we do use a contractor to help us do some of what we call our servicing reviews and claims reviews where they go on-site to review a lender's performance in those areas.

It has been reasonably lucrative so far. I think we have recovered about 25 million dollars in the last two or three years based on these types of reviews. I want to emphasize that in my area, the quality assurance area of FHA, we are a growth industry. We have doubled our size recently and we are going to double again in another couple of years. We are restructuring really how we do business, not only on the quality assurance part but other areas of HUD as well.

We will eventually have what we call 5 home ownership centers. We just opened two yesterday, Atlanta and Philadelphia, and Denver was opened some time ago. Each one of those home ownership centers, and two more to follow, will have its own quality assurance division, sort of a mirror image of the one I have, and they in turn will go out and do these lender reviews. But again, we are sort of in a growth area. The main reason primarily being that we have turned so many responsibilities over to the lenders, and we feel obviously it is in our best interest to monitor those closely.

The last thing I want to talk about is somewhat unusual and I think it is going to work. Last Friday, our FHA commissioner, Nick Retsinas, signed an agreement with the trade association for mortgage lenders called the MBA or Mortgage Bankers Association, whereby we are in a sense making a contract with the MBA and other lenders who wish to sign up so to speak, that HUD will look at lenders who come forth with problems that they discover in their quality control plan and maybe work out a financial arrangement that is not quite as heavy as it is now. It is sort of incentivizing, if you will, lenders to report fraud on themselves. Lenders do that already but not to the degree that we think is really necessary. So we want to encourage lenders to come forth. By doing so, we think we are going to find out areas and individuals or players as we call them that abuse our programs a lot faster than by trying to do the job alone. So it is sort of a partnering outfit or agreement, I should say, where we are reaching an accord with the lenders and with the MBA to have them come forward so we can share their information and trying as best as we can to curb mortgage abuse.

The last thing that we just recently published, and it is new for us as well, is a consumer pamphlet that basically is entitled, "How To Avoid Mortgage Finance Fraud or Loan Fraud." That goes through certain steps that individuals or prospective mortgagors can review to make sure they are not being a victim of loan fraud.

Again, these are some of the initiatives that we have underway at FHA. If you have questions, I will be glad to answer them when we go to the Q&A session. Thanks.

MODERATOR KESTERMAN: Thank you, Parker. Our next speaker is Walter Intlekofer from SBA to deal with Autodial and related matters.

MR. INTLEKOFER: Shifting gears quite a bit, going from the private sector lender standpoint to a federal agency perspective, I want to give a very brief overview of some of SBA's automated systems that we use to service direct loans.

Most of SBA's portfolio is lender serviced, that is, the business portfolio. In addition to the business loans, the agency makes quite a few disaster loans, and it seems to be in an increasing number recently. We have now about 275,000 disaster loans worth about 7 billion dollars, and these loans are the primary focus of our own internal collection systems. One of our primary strategies in collecting loans is to keep a loan from going delinquent in the first place. We have a notice that is sent out automatically to each borrower 15 days before the due date, pretty much like you get from your mortgage lender. The notice has the payment that is due, the application of the last payment, the outstanding balance on the loan, and so forth.

If a payment is not received on a loan within 10 days of the due date, our computer system automatically sends out an overdue notice that comes out of our Denver accounting office. In addition, when the payment is not made, that particular loan is loaded into an automated system called our delinquent loan collection system. The system basically provides an automated way for our loan collectors in our various offices throughout the country to follow up very quickly on a defaulted loan. As is common knowledge, a debtor will pay an account where he is called up, where he receives letters, where he is aware that some attention is being paid to the delinquent debt. If a creditor ignores a loan, especially a federal agency, the debtor undoubtedly will be very slow in paying.

The delinquent loan collection system that SBA uses consists of a series of computer screens that provide information on the delinquent accounts. These accounts are grouped by loan collector in our collection centers, and they are listed according to the age of delinquency with the most severe delinquent accounts being listed first. The collectors then follow up with these screens, these on-line screens. They call the borrower and make any comments using an on-line entry system, and that entry then forms part of the chronological record of that particular account. This saves actually going through a physical loan file and wondering whether that file is up-to-date.

The collectors also confirm the calls and any arrangements made with the debtors by a series of letters from SBA's automated message system. There are quite a few letters that are available with data extracted from SBA's loan accounting systems entered into the letter in the appropriate places along with the debtor identification.

Over the past decade, the use of automated systems by SBA has increased the currency rate on the disaster loan portfolio by about 10 percent, from 79 percent to 89 percent, where it is currently. One of the fairly recent improvements, about three years ago, SBA started using an Autodial system. You probably all have received calls around dinnertime at home and you notice that they are from these various solicitors. You notice that there is a slight delay after you answer and then a live person comes on the phone. That is undoubtedly an Autodialer.

SBA has found in the past that the time spent in actually dialing up the telephone number of a borrower takes quite a bit of the time and actually contacting a lender as opposed to actually making a live connection. The Autodialer system has increased the efficiency of our collection process by about 3 to 4 times. The average number of live collection calls that our loan officers have been able to make without Autodial has been about 50 a day. With the Autodial system, this has increased to between 150 and 200 for the average collector.

Using the Autodial system, loans are stratified also according to the type of delinquency, the age of delinquency, and when a live contact is made, account information is automatically pulled up and a live collector at a computer screen actually handles the call with the debtor who answers the phone. And from that summary screen, the collector can go to a wide variety of informational screens that have to do with information on the particular account to answer any questions that the borrower may have.

We also leave -- unlike some Autodial users, we leave information on home recording systems. We have found that this -- and we leave an 800 number for the borrower to contact SBA, we have found that that has actually worked, believe it or not, because the borrower is made aware that at least SBA is cognizant of the fact that the loan is overdue and is monitoring the account. Oftentimes, the borrower will use the 800 number to call SBA about the delinquency.

After an account reaches a certain stage of delinquency, SBA uses another system called the liquidation litigation tracking system, which is another set of computer screens that contain information about the account. It contains the liquidation plan, information on collateral, information on all the principals associated with a particular account, and allows intensive on-line working of a particular loan. This system can be accessed from around the country, so even in Washington here we can oversee what particular accounts are doing in any of our 80 field offices.

Finally, SBA is a full participant in many of the government-wide processes such as tax refund offset, the Treasury's new administrative offset program, the federal salary offset, the use of private collection agencies after we have liquidated collateral, and so forth. If you have any questions, I also will be available in the panel here.

MODERATOR KESTERMAN: Thank you, Walter. A lot of interesting material this afternoon. We will have one more speaker and then we will have a question and answer period. While our next speaker is coming up to the podium, let me tell our television office the TV number is 1-888-924-3246, if you would like to start to get your questions ready.

Ted Foster is with Government National Mortgage Association, known as Ginnie Mae. He is going to be dealing with two subjects, their acronyms are IPADS and CPADS. In the interest of time, I am going to let him tell you about that.

MR. FOSTER: Thank you, Frank. Two systems, IPADS and CPADS -- earlier it was described. The IPADS system is the Issuer Portfolio Analysis Data Base System. CPADS is the Portfolio Analysis Database System part, but it is correspondent.

These are systems that are used to monitor the issuers of mortgage bank securities in the Government National Mortgage Association's portfolio, and then to take that further to use information from FHA and from the VA and monitor that down to the originators of those loans. Let me give you a little background on Ginnie Mae. We are guarantors of mortgage bank securities, banks and mortgage companies and thrifts pool mortgages that are insured by FHA and VA, and then we guarantee the performance of those mortgage companies to the ultimate investor, the security holders. We have a portfolio of about 485 billion dollars. We originate approximately 100 billion dollars in securities in any given year. We have about 500 participants, the banks, thrifts, and mortgage companies, and about 350 of those maintain mortgage servicing portfolios.

The objective when we developed IPADS in 1989 -- actually, let me give you a quick story. In 1989, we had a portfolio of about 200 billion dollars and 11 billion dollars of those defaulted back to Ginnie Mae. This is not a circumstance that we like to have. What Ginnie May does -- this is failure to perform on the mortgage companies part -- failure to pay the security holders. Ginnie Mae steps in and takes over that portfolio. Bad news number one was the fact that it occurred. Bad news number two was the fact that after this was defaulted, we looked at one another and said, who do you think is the most likely to have this occur again? And no one really had a very good sense of who that was. By word of mouth, we thought it might be so and so and so and so, but really we had no collective process for identifying someone who may be a problem in the future.

So we sat down and said, okay, what we really need is a coherent automated system that can identify the folks that are most likely to be a problem in the future. Through that process, we developed the IPADS system. What the IPADS system does is it takes monthly reporting on the performance of pools of mortgages and compares a mortgage company, bank, or S&Ls performance against national averages. This is the first step.

We then, as we became more sophisticated about our analysis, we knew that, as Parker has mentioned, there are niches where you have to recognize that someone who is lending in New England in the early 1990's clearly has different problems than someone who is lending in the Midwest. As there are economic downturns regionally, it is going to unevenly impact our participants.

So IPADS was refined to take into consideration these geographic uniqueness of a portfolio, and we came up with a number of areas where we could use weighted averages. So we could actually compare an institution that is exclusively lending in New England in the early 1990's with the performance of loans in New England. So it gave us a much more refined ability to analyze folks.

Using the analytical system, we then put together a small team of people who identified the worst participants using this system and then we were in constant contact with these folks, the objective being to say to them, we have the raw data. We don't know your story particularly. What we can tell you is that statistically, your performance doesn't look very well relative to other participants in the program. You tell us what your problem is or you tell us what the story is, better yet -- putting it in the positive -- and you tell us where we can expect to go statistically going forward, and we monitored those folks.

The IPADS system we have been extremely pleased with. We had 11 billion dollars of default in one year. In the subsequent 6 or 7 years, that has been reduced to a cumulative of about 4 billion dollars. So we have been very, very happy with how IPADS in conjunction with the special teams working on that -- how that has reduced delinquencies.

Now we move from IPADS to CPADS. We introduce new information and we introduce additional players. CPADS takes the Ginnie Mae data, which is the basis of IPADS, and it says you know this is half the story. This is the story of how the loans are doing today with a given mortgage servicer. The story that is missing is that these loans may have changed hands multiple times from the originator, the folks that put the original mortgage insurance on the loans by FHA. CPADS was created by matching the origination data, which was available through FHA and VA, with what we had in servicing data.

Together, we came up with a system that can take the issuer and say this is where they are in static, and then as if it is a prism or a matrix, turn that 90 degrees so that you can say, okay, these folks are doing -- in static, this is what the portfolio looks like, but this is where these loans came from. And we can follow those loans back to their origination source. It has been very effective in multiple ways. As Ginnie Mae, it completes a story that we only have partial information on. We know now who has business relationships with whom. We know where the source of problems may lie as opposed to just what we see as symptoms. And I

think most critically, it brings the three parties together in FHA, VA, and Ginnie Mae, who need to work together. It gives us a system around which we all talk from the same page, and its evolution brings us together to share what can be the improvements and what we see through our unique circumstance to improve overall monitoring of the program.

So we approach it from how are folks servicing their portfolio, because ultimately our risk is how they service and then pay the investors. FHA and VA are on traditionally the other side. How are these folks originating these loans because their liability lies in the insurance they are providing that independent of the performance of the borrower, the mortgage company, bank, or thrift will be made whole. So by creating CPADS and bringing us all together on a project like CPADS, it covers the whole gamut from borrower through institution -- mortgage company, bank, thrift -- to the investor, and we feel like we have provided protection from beginning to end.

We have both CPADS and IPADS set up in the hallway as a demonstration. For those that are interested, please come by and we can run you through both systems or either system. What I would like to acknowledge is that we now -- this has been an excellent system developed among FHA/VA and our contractor, Coopers & Lybrand, and it has been one of those things that we feel has brought us together -- FHA, VA, and Ginnie Mae -- to really get a coherent monitoring in place. We would like to thank Frank again. CPADS was a Hammer Award recipient, and we thank Frank and the Treasury for doing that. Again, any questions, please come in the hallway or after the panel, and we would like to answer those questions. Thank you very much.

MODERATOR KESTERMAN: Okay. We're going to make another schedule change here because we caught up a little time. There is a related agency that uses CPADS, the VA. And Gerald Ference from the Loan Guarantee Service will explain how they are using it in their lender monitoring and auditing process.

MR. FERENCE: Thank you, Frank. Good afternoon, ladies and gentlemen. I am Gerald Ference with the Department of Veterans Affairs Loan Guarantee Service Monitoring Unit. For those of you who are not too familiar with VA's program, it is commonly known as the GI Home Loan Program. It is a method by which a veteran of our armed services can obtain a loan to buy a home by financing 100 percent of the purchase price. VA doesn't make the loans directly. We use private lenders such as banks, mortgage companies, insurance companies, credit unions. They make the loans and we guarantee them against loss.

Over 15 million VA loans have been made since 1944 when the program began. During the past 5 years, over one and a quarter million veterans obtained VA loans. So it has a significant impact on the economy. The value of the loans made during the last 5 years exceeds 171 billion dollars. The contingent liability to the government is over 57 billion dollars.

We have about 4,900 lenders who are actively making loans, and we have a challenge since we have a monitoring staff of roughly 15 people that are out-based in our field offices that have to review the performance of those lenders. We are vulnerable to poor loan origination because of the high loan to value ratios in those loans.

But thanks to Ginnie Mae and its willingness to share CPADS with us, we are able to work faster, smarter, and more accurately. We now have the ability to timely identify the riskiest lenders based on recent loan originations, select the worst lenders for review, and reduce our risk by a more improved oversight of program participants. CPADS has also enhanced our ability to recover cash from lenders who originated loans that do not meet the requirements of the law. We obtain more indemnification agreements covering loans that should not have been made because of undue risk characteristics.

We make maximum use of the features in CPADS that identify the lenders whose performance is worse than the norm and the specific loans that have gone into early delinquency. Normally, these delinquencies occur within the first 12 payments. The supplemental data that we get from CPADS gives us loan level information so that our audit teams can actually look at the loan files in the lenders offices, and we advise the lenders of our findings and work with it to correct its practices and approve the overall quality of its loans.

CPADS provides interesting information to us in two ways. The first of which is through a specific lender query, and another way is through a series of management query screens that give us a clear view into VA's loan portfolio. At the portfolio level, we see a snapshot of our program averages for the originations and delinquencies grouped according to general lender sizes, roughly 4 lender categories. We can now see at a glance that approximately 200 of our 4,907 lenders make 67 percent of our loans. That has enabled us to focus our reviews much more coherently than previously.

We also see at a state level that the delinquency rates vary according to the economic conditions in a given area. We see that some states perform better than others and are relatively comfortable with the lenders' originations in those areas. Those states that have problem loans, however, merit close attention. At the correspondent level, CPADS shows us the worst small, medium, and large lenders in both raw numbers as well as adjusted delinquency ratios adjusted for the age and location of the loans. It shows which lenders originated the highest percentages of loans during the last 12 months, who are the largest active lenders according to the dollar volume of the loans that are made, and who had the highest percentage of recent originations during the past three months to one year.

One of the nice features about CPADS is that it has given us the ability to look down into a three digit zip code area and find out where the highest number of loans are, and also the three digit zip codes that have the worst loan performance, that is, the highest delinquency ratios. With this insight into the portfolios performance and the names of the biggest and worst players, we are able to establish an audit schedule by focusing our resources where they will be most productive. We look at lenders who originate the highest volume of loans as well as those whose loans have the highest number of delinquencies.

When looking at a specific lender's CPADS information, we look at their numbers two ways, their raw delinquency data as well as adjusted data. Adjustments are made for the age and location of the loans. That gives us the insight to know whether a lender is performing worse than other lenders of similar size in a given locale. So, therefore, the lender cannot say that poor economics is causing problems for us. We can point back to the lender and say that other comparable size lenders are doing much better and you must have an origination problem that merits some attention.

I would like to summarize by pointing out one of the benefits of the active monitoring that we have been doing over the past 6 years. It has been improved as a result of CPADS. In a comparable period of time from 1985 through 1989, about 1,412,000 VA loans were made and 81,514,00 have been liquidated. Recently, in the period from 1990 through 1994, we have made 1,640,000 loans, and only 35,176,000 have been liquidated. So as a result of CPADS and our improved oversight, we have been able to help lenders improve the quality of their loans which results in a lower number of liquidated loans, and of course savings to the taxpayer. We are getting good value for the money that has been spent on CPADS. I would encourage you to come by and take a look at CPADS and IPADS out in the lobby. Thank you very much.

MODERATOR KESTERMAN: Thank you, Ed. That wraps ups this part of the panel. We would like now to take questions from the audience.

MR. FOSTER: Frank, I would like to ask Parker if he could expand on the MBA -- the deal with the MBA that was struck last week.

MR. DEAL: The quality assurance agreement?

MR. FOSTER: Yes.

MR. DEAL: Again, and I will slow up a little this time. Sometimes I talk too fast. We feel, and likely so, there is no way that FHA's monitoring can do the job alone. As I have mentioned, in recent years, a number of lenders have come forward telling on themselves or others. We appreciate it either way. But obviously if a lender comes forward right now and says, hey, I have uncovered fraud in my shop, that lender is obviously exposed financially to the department. They are still going to be exposed, but I think this is an agreement that we want to have with lenders where we can perhaps share the risk. What we are saying is that if you do step forward, we will incentivize your efforts by assuming some of that risk ourselves. We will see how this goes. Again, this is kind of a new thing for FHA. I will say that the MBA or Mortgage Bankers Association is very aggressive in promoting lender quality control. We have worked with them on many, many presentations, and I think this is an opportunity, again, for a lender. So many of the larger lenders particularly are doing aggressive quality control. They can say, look, we have found problems but FHA at least will listen to us and perhaps the outcome won't be as severe as it otherwise would be. So that is essentially what we are talking about.

MODERATOR KESTERMAN: This lady over here in red?

PARTICIPANT: I have a question with regard to the SWAT program. What steps are you all taking -- I know you are looking at problems -- financial and physical problems -- are you taking steps to help owners and managers to find additional community resources? Are you working with them to put together action plans? What steps are being taken to help solve the issue in the communities?

MR. KERRY: All of the above. All of the things that you described. One of the things that we are also doing is we are working with owners so that they come to see that their properties are affected by the neighborhood that they live in and the reverse. But really the first step is getting the owners to understand that they have a problem. Because with the ownership structure of many of these multi-family properties, they are in what is known as limited partnerships. So you actually have several tiers of owners. You have upper tier limited partners. You have upper tier general partners. You have lower tier general partners. So many times the department's interaction with the property has not been with the owner at all, but it has been with the person who managed the property as opposed to the owners. So one of the first steps we have taken is making sure that we are in touch with the owner. And as I say, the owner in the cases of many of these properties actually means two or three different sets of people who might have two or three different sets of objectives.

But our main focus is that the owners have signed regulatory agreements with the department, both regulatory agreements attached to the mortgages and there have been cases where the properties have been subsidized and they have also signed housing assistance payments. And in both cases, they have agreed to maintain the property and that is in large part what we are out there to do is to make sure that they are doing it. One of the interesting things that comes about in these discussions is a clarification of roles because many times the owners -- not all of them, but some of the owners begin the conversations by saying how come you didn't tell me I had these problems in the first place. And if you remember the diagram that we had up here, HUD's role in these properties -- HUD is not the owner of the properties. HUD is not even the lender on the properties. HUD is insuring the loans that are on the properties. The responsibility for the upkeep of the property is with the owner.

PARTICIPANT: My question is on the CPADS. It sounds to me as if the systems will allow you to create sort of like a report card for your lenders and is it anticipated that instead of just doing gotcha with these guys that you could send them referring report cards so that they could figure out whether or not they have got a problem or not or are you anticipating doing that?

MR. FOSTER: Let me answer it on the Ginnie Mae side. That -- I unfortunately left part of the whole thing out and that is that they receive quarterly reports from Ginnie Mae -- the mortgage companies, banks, and thrifts do -- on their servicing performance which is like a self-monitoring technique. The other thing is that we try not to, when we do find someone who is exceeding averages, we try not to set it in an adversarial way. The objective is to say to them, please explain your story to us. You set the standards for your own performance, and we will monitor you to those.

So we've got -- one is that the approach is not -- the intent is not a gotcha. And the second is that there is a quarterly report which in fact we are going to do focus groups on over the next 6 months to improve what goes out to these folks once a quarter. The third thing, way down the road, is that we probably will get better information on a monthly basis and we may have something on-line where these folks can just get on-line on a regular basis be able to go to the system and say where do I stand relative to averages.

MODERATOR STANTON: I have a question if I might, Frank, just responding to that. I guess when I hear you, Ted, talk about Ginnie Mae and writing to somebody who has an above-average delinquency rate or maybe even a really bad delinquency rate saying we are not trying to be mean here but could you please explain yourself, it is my impression that the private secondary market agencies aren't quite as benevolent. That if they call somebody up and say you are really shipping us a lot of bad stuff, the response is either repurchase it or we are going to pull your servicing. Do I hear a theme in each of these agencies which may resonate with the agencies out in the room that in fact you've got a lot less enforcement resources to carry out your contractual rights with respect to the originators and servicers of your guaranteed loans? Is that sort of a common theme here? And is the important lesson we are learning from these best practices basically how you are dealing within those constraints or something else?

MR. FOSTER: On Ginnie Mae's side, I can say you are right on, Tom, in that we have less resources. The second is relative to Fannie Mae and Freddie Mac, we have less of a range of resource. Truly with Ginnie Mae, we have very little, shy of defaulting mortgage servicers, we have very little middle ground. And certainly we don't want to go to that last point of recourse. So it is collaborative with the mortgage servicer by necessity.

MODERATOR KESTERMAN: If we could ask Gerald to comment on that question. I am always impressed with how few auditors you have and how many loans and lenders you have to review.

MR. FERENCE: We have a similar problem. We do have constraints, due process, et cetera. But when we do our audits and we find a particularly egregious loan or series of loans, we will try to recover the claims that we have paid so that there is a dollar impact on the lender or get indemnification agreements. There are occasional cases where we deny guarantee liability on the loan. That also has a dollar impact on a lender. That provides an incentive to improve. A lender who continues to perform poorly and perhaps ignores good practices is always subject to debarment actions, but again we are dealing with due process rights there and it is a lengthy and time consuming practice. We would rather work with lenders to improve their operations so that they continue to stay in business making quality loans and helping our clientele, which are veterans.

MR. KERRY: I would add to that that if you remember the pyramid that we were looking at, there have been several studies that show that what we were talking about on the video is absolutely correct, and that was the theme that I heard running through most of the other presentations. That is that most of the loans that the Department has made in multi-family side, and it sounded to me the same way with SBA and on the single-family HUD side, were good loans -- are good loans, and that the portfolio is in very good condition. One of the things that we are trying to do, and this is the reason that the president of NAMA was on the video, is that when you have a situation where most of the owners of these properties are doing the very best that they can to keep them up and to run them, it is totally unfair to those people to have a very small group of owners not do that and part of the department's responsibility is to make sure that everybody is playing on a level playing field and that the regulatory agreements that everybody has and that most people are living up to are lived up to by everyone.

MODERATOR STANTON: Let me ask then the question, what are the constraints, if any, of moving the resources allocated to SWAT up so that you can move higher up that triangle and get a much larger percentage of the bad actors that you need to deal with? What are the realistic constraints to that process?

MR. KERRY: Well, there is a presumption in your question which is that there is more to find. And one of the things that the department has done -- it is not the topic for my discussion, but you have heard some of it on the single family side -- is that the department over the last couple of years has become, as all these other agencies have, smarter and smarter and better and better informed about the state of their portfolio. The difference is that we, I guess like the SBA, are really dealing on the retail end of this. Because these 16,000 properties are literally 16,000 individual properties and individual neighborhoods with individual sets of owners, and that is why, as Mr. Retsinas said, it is very labor intensive. The constraint that there has been on SWAT, to the extent that there is a constraint, is an information constraint about the department being able to identify which properties should we go to work on.

MODERATOR KESTERMAN: Jack, would you say something about the SWAT case load versus the normal case load?

MR. KERRY: Yes. The average asset manager within the department -- and that distinction is an interesting one because within the department there used to be two types of people -- people on the development side, that is, the originators, and then there used to be people that worked in what was known as the management side of HUD, that is, once the loan was up and going who supervised it. The term asset manager came into being to reflect the fact that for many of the properties that we are dealing with, they are now 20 and 30 years old, and they have a need for a large amount of reinvestment and therefore you need a different kind of person looking at it. You need an asset manager looking at it.

The average asset manager has about 60 or 70 properties in their portfolio across the country. The average SWAT member is expected to take a property from beginning to end, that is, to diagnose the property, figure out what is wrong, work with the owner to come up with a solution to the problem, and have it come out the other end, whatever come out the other end means. We define that as being that the property is in good condition. The SWAT members portfolio is about 12 to 15 properties a year as opposed to the 60 to 70 that a normal asset manager would have in one of the field offices.

MODERATOR KESTERMAN: Again, resource constraints that face us all. Questions from the audience? We are having a good time up here. We are going to ask more questions amongst ourselves. Parker, can you talk about disbarment? Has FHA disbarred a lender yet?

MR. DEAL: At FHA?

MODERATOR KESTERMAN: Yes.

MR. DEAL: Oh, yes. There is only one entity at FHA that can take an approval away once it is given and that is called the Department Mortgagee Review Board, commonly called the MRB. It is due process. Virtually 90 percent of all the cases that are heard before the board, the MRB, are cases that we referred to them out of my division, the Quality Assurance Division. We have that new tool that I mentioned earlier in my presentation. It is system driven where it tells us about the performance of lenders on a quantitative basis as far as if their default rate is so egregious that we don't want to do business with them anymore. So we have the authority to terminate a lender's approval that way.

Just to kind of reiterate on the other question, we have probably about 16,000 to 18,000 approved lenders. That is a very large lender base. We will do somewhere between three quarters to a million homes a year. My staff numbers about 45, and that has recently been doubled. We will double that again in the next couple of years. So we are pouring some resources into this as far as actual individuals or bodies if you will. They are not new people. They are being redeployed, I guess is the term, from other areas of HUD. But those bodies are available to us. So we are going to have more people.

Our systems -- we are spending a lot of time on that. Not only on the MPAS system that I mentioned earlier, but we are, as we all should be, a performance-based operation. We want to get as much information on a lender's performance as we can so that we can target our resources and use them effectively.

Thirdly, the next item that we are doing -- because we can't do the job alone, it is impossible -- is that we are trying to partner with the industry to encourage them to self-police. There is a lot of interest in that, and again hopefully this agreement that we signed last week with the MBA and other lenders that will sign with us in the future, will encourage them or incentivize them to step forward and share their stories of woe with us. Certainly, they will have to pay a price for that, but again that price will be reduced if they come forward in a timely manner.

PARTICIPANT: Along those lines, have you had any conversations with Fannie Mae or Freddie Mac? I know they have some fairly rigorous follow-through with lenders along with programs themselves.

MR. DEAL: The question, if everybody couldn't hear it, is do we maintain contact or networks with other individuals like Freddie and Fannie? We do as much as we can. As I have seen the development of quality control over the years, it has gone from a primitive state to a much more sophisticated state with systems leading the way for a lot of us.

Yes, we do share information. We have an MOU with Ginnie Mae and we are developing one now with the FBI. There is a lot of interest with the FBI on mortgage finance fraud. In fact, they are putting on a fraud workshop later this month in Chicago, where a lot of the individuals and people involved in mortgage finance are going to be attending. So there is this momentum, if you will, to share information and to get people together. If they are doing it to FHA, they are doing it to VA and they are doing it to Fannie and they are doing it to Freddie.

It does seem like we have found over the years that mortgage finance fraud not only is alive and well, but it is becoming a little more high tech in many respects. We have to keep pace with that. Thus, this partnering with the industry and with others that are insurers and whatnot is very important to all of us.

MODERATOR KESTERMAN: Any questions? Back row.

PARTICIPANT: Yes. I was wondering -- what I am sensing from this conversation is that the government seems to take, I guess, a soft -- I mean, they are getting tougher about it, but less than a onslaught relationship with many of its proprietors. I am just wondering what are the political consequences or what policy ideas you might have to maybe toughen or strengthen options for enforcement actions? It seems that the policy considerations all seem to prevent or at least that is the excuse or rationale used, that we don't want to take a tougher stand with some of these loaners.

MODERATOR KESTERMAN: Let's direct that question to SBA.

MR. INTLEKOFER: As you know, Tony, SBA does deal with individual lenders on a loan by loan basis with respect to not honoring the guarantee on a loan or if we have already paid on the guarantee, suing an individual lender. If it seems to be more than just an individual loan problem and a pervasive difficulty with the lender and originating, servicing, or liquidating, then SBA will certainly consider no longer participating with that particular lender. There are some implications, though, for the larger lenders, and there is some inertia to overcome to reverse a long period of participation with a particular lender. But certainly SBA is taking a more aggressive stance on dealing with its own participants.

MODERATOR KESTERMAN: Thank you. Last question.

PARTICIPANT: I believe earlier, Parker mentioned a return of a million as a result of assessing the monitoring efforts, and I was wondering if we could hear more about what that million actually represents.

MR. DEAL: Okay. Let me just start out by saying that in any program like we have, we are always in a balancing act. We want to encourage the lenders to use the FHA programs to provide home ownership opportunities using an FHA program if so desired. So we are balancing this policy directive, so to speak, along with what I call a very aggressive enforcement program -- sort of a tough love, if you will. But generally parents make this same mistake in a sense. One way to get a lenders attention is in the pocketbook, and certainly that is where you have to have some effect.

MODERATOR KESTERMAN: Parker, excuse me. We are running out of time. For the television audience, we will see you tomorrow at 11:30 to 12:30 eastern standard time, at which time we will be dealing with financial early warning systems, and the afternoon session from 2:00 p.m. to 3:30 eastern standard time, customer service issues, mapping of federal assistance, and some interesting EDI applications. Hope to see you tomorrow. Goodbye. You can keep going.

MR. DEAL: Oh. All right. So what have we done? Certainly if a lender's performance is extremely aggressive, we kick him out of the program. We take their approval away. But that doesn't happen that often because most of the time it is somebody on the lender's staff, not at a high level, that is involved in some of the problems that we find out. Now that person that commits fraud certainly is subject to suspension and debarment actions, and we take a lot of those. But as far as the punitive part with lenders and the money aspect of it, I mentioned 25 million in the last three years or so. That is probably on the low side. That is primarily an accumulation of what we call lender indemnification agreements. Where they sign agreements not to submit claims to HUD or to reimburse HUD if things have already been submitted. We also get a lot of cash settlements as well and civil money penalties. I think this past year we have gotten $100,000.00 to $200,000.00 in civil money penalties. That is not all directed at lenders. Quite often that is directed at other players in the mortgage transaction. It could be realtors, builders, sellers, and things of that nature.

But yes, if you have an aggressive program, you try to balance it. Let the lenders know where you are coming from. We do a lot of lenders, in a sense, education, telling them what the rules are and what we expect of them and create that level playing field. You sort of disarm them as far as any complaints they have against you. So that is sort of where we are coming from. Most of our monetary rewards, if you will, come from indemnification agreements.

MODERATOR KESTERMAN: Thank you. Is Steve Solomon here? Come on up, Steve. It is your turn. Steve Solomon is with the Credit Management Improvement staff of the U.S. Department of Education, and he is going to discuss with us monitoring financial responsibility of participating schools.

MR. SOLOMON: Good afternoon. The fact that we are off TV is not a problem for me even though I thought that we were being picked up in Japan or it said something about Japanese television, but I was planning on speaking in English anyway. As a long suffering Cleveland Indians fan, I was kind of hoping that we could move this to Camden Yards before we had this discussion, but apparently we weren't able to pull that off.

The issue I am here to discuss is monitoring financial responsibility of participating schools. I am with the Chief Financial Officers Office of the U.S. Department of Education. The effort for monitoring financial reporting is handled out of our office of post-secondary education, specifically in the Financial Analysis Branch of an area called IPOS, which is the Institution Participation and Oversight Staff. It is the area where they are actually determining whether schools should get into the Student Financial Aid Program, and once they are in the program, monitoring schools to make sure that they are meeting our legislative and regulatory requirements to stay in the program.

I also want to thank the Federal Credit Institute for inviting me to do this presentation, and I also wanted to kind of congratulate and also mention -- Francis Meyer is a person in the Office of Post-Secondary Education who pretty much headed up this effort. In a minute, I will tell you how the CFO's office got involved in it, but he pretty much worked this all through, and we feel it is a very successful effort, and you will see how we have included it in our regulations.

So to briefly go through and try and tell a story. I have two little kids, so it is easier for me to do it that way. The problem that we had -- again, I mention gatekeeping, our gatekeeping efforts. Two sides of the gatekeeping are, one, deciding when an institution can get into the program. The other effort is monitoring them once they are in.

One of the things that we look for in determining whether a school should get into the program and stay in the program is whether they are financially responsible or not or viable. In other words, if an institution or a school appears to be going under, it presents a number of risks to our players. Most importantly our concern is that the students who we are hoping that this institution is going to help out by providing educational opportunities, they won't be able to provide that because they went under. It threatens federal resources at the institution because we have given them -- our structure is that we advance money. We give money to the schools to provide the services. If they go under, clearly that money is going to be lost. And thirdly, as you can imagine, when we have done any kind of risk analysis on our part, the likelihood of fraud and abuse of the program is much higher for institutions that have gone under or that are about to go under.

So that was the problem that we were trying to solve. The other issue that we have is that we have over 7,000 institutions that we are trying to monitor. Of those institutions, they represent a number of different disciplines. Some are public schools. Some are not-for-profit schools -- you know, Harvard, Yale, et cetera. Some are for-profit schools. They can be beauty schools, welding schools, et cetera. And some of them are hospitals. Each one of those different disciplines has its own separate accounting structure and methodology for reporting. That presents another complicated avenue for us.

In addition to this, as I am delighted to hear that other people were mentioning, resource constraints that the department has, like everybody right now during a time of downsizing, indicates that we only have pretty much a handful of people to review these 7,000 audit reports from the different environments. So, as you can see, it is quite a daunting task.

The solution that we came up with for solving this problem was using financial ratio analysis. As you see when I talk through it, some of the ratios that we used will be used in a process of risk analysis that is very similar to the efforts that were being done by Ginnie Mae and the other systems, and we are also working with Coopers in that effort.

We chose to use ratio analysis. Now ratio analysis is a methodology that the department had been using pretty much since the 1970's to try to get information on these schools. The problem that we consistently had using these ratios is when we requested the information from the schools, they deemed it as a burden because they had to provide specific things just for the Department of Education. So it was an extra effort for them. From our perspective, it was very problematic because we would get information from each one of these different schools in a format that was unique to them. And given the volume of information that was coming in, it made it very difficult for us to process in an efficient way. Therefore, we wound up doing sampling techniques rather than being able to sufficiently cover the whole scope of what we were trying to do.

What changed us was legislation that we put through during reauthorization for the Higher Education Act which governs student financial assistance in 1992. In that legislation, we instituted a requirement that -- or Congress instituted a requirement that institutions had to provide the department on an annual basis audited financial statements. This really solved most of the problems that I identified. These institutions were preparing the statements anyhow for bond reasons and for their own purposes, so it really wasn't an additional burden for them. And it provided us information in a standard format, based on the different discipline or industry that they were in, on a timely basis. So we were able to get that information.

We instituted regulations in 1994 as to how we wanted ratios to be done based on these financial statements. The initial effort that we did with these ratios pretty much focused in on short-term liquidity ratios and those were very useful for the majority of people in terms of determining whether they were viable or not. What we found out is in some cases we felt that there were things that we could improve based on that. We were looking at liquidity focusing on certain areas rather than looking at the total picture of the entity. We determined that we could do better.

Our effort to do better, as I have noticed with other speakers too, is we engage a contract with KPMG Peat Marwick, who is a leader in the field of higher education ratio analysis. They do a lot of work with Moody's and Standard and Poor's. We asked them to come up with specific ratios for the different disciplines -- public, not-for-profit -- so we could take the accounting information and do some kind of a risk analysis on it, specifically focused on what schools would have the greatest likelihood of going under.

The process that they went through, that I will explain in a minute, took about a year and it resulted in this report which was issued August 1. Again, copies are available at the department if anybody is interested. I would be happy to get you that information. When they kicked off this effort, Peat Marwick started off using about 9 different ratios that they felt would be most appropriate. What they determined after they started doing this was they really could pare it down to three, and I will go through those. But they could go down to three ratios to use the analysis, and that nine was actually far too burdensome even for them to review, let alone the department. So one of the things that everybody is always taking into consideration whenever we do any kind of analysis is can we actually implement and how burdensome is it with the resources we have. So that kind of went all the way through the analysis.

The ratios they used were viability, which is kind of an equity to debt ratio for the school, primary reserve, which was equity to expenditures, and net income, which pretty much determines the profitability of the institution. The other step that they did during that year was they convened a panel of top people in each one of the disciplines. They had people from public schools and private schools and for-profits, et cetera. They came into Washington and they spoke with them about what their feelings were about the ratios, could we do it, and how it would effect them. Most specifically, how we could make it the best indicators within their industries. I was fortunate because we had the Chief Financial Officers to participate in this too. This is really where I kind of got involved in the study.

At the same time that they convened the panel of people from the higher education community, they also worked with the CPA community, who was out there doing the audits to make sure that the information would be available to do the ratios on. When we got all the financial statements that we would be able to pick out what we needed.

They tested the ratios against 205 schools. What they tried to do was a random sample from each one of the industries. Of those 205 schools, they specifically picked a section of schools that were either already identified as problem schools that we were getting letters of credit on or some security from, or they picked schools that had already closed. They used these indicators kind of backwards to make sure that they were good predictive factors, and they determined that they were good predictive factors.

The other thing that they used is they weighted the risk categories as they were doing the analysis by industry. So in other words, profitability was a much more important criteria to rate a for-profit school, which is logical, than it would be in the public schools. The same thing with the public schools. If they were more likely to have debt, we looked at those categories a little stronger.

So basically it was a year-long process. What did we do with it? We got the report, which was great, and a lot of people have it lying on their desks. More importantly what we did with it was we issued a notice of public rulemaking on September 20, incorporating the principles in risk analysis and the financial ratios into reg or into draft reg. We are hoping to publish that reg on December 1 and institute this thing starting July 1, 1997. Basically, the report itself was taken and pretty much put directly into the Federal Register.

As I mentioned before, what this study will be used for is a piece -- the financial piece to determine viability. But there is a bigger piece that the department is looking toward in its monitoring of institutions. The whole risk analysis approach which was used in the Single Audit Act and a number of other things basically saying let's switch our resources, as dwindling as they may be. Let's take our resources away from working heavily with everybody.

Let's focus possibly less on the people that we know are not presenting us problems and really put our resources toward the people that are presenting us problems, both to identify where those problem areas are and possibly to help those entities out as much as we can and also take action against them if we see that the federal interests are being hurt. That is pretty much it. I want to thank you again for inviting us.

MODERATOR KESTERMAN: Tom Stanton has the first question.

MODERATOR STANTON: It is great to sit up here. This is really wonderful. Every time we turn to another agency, as far as I am concerned we find another fascinating example of real process improvement. I need to ask a question. I know it is not your department, but building on the questions that were asked of the people that are supervising mortgage lenders, what happens when you find somebody who doesn't score too well? What is your sense of the steps you would take to deal with the issue? What do you call a problem? Do you then look at the quality of the loans they are sending you? What is it you do?

MR. SOLOMON: Okay. In this case, what would happen is -- the one area I am specifically talking about is financial viability. So what would happen is a trigger would come in basically saying that the institution, for instance, does not have enough money to make it through the year. Their debts far exceed whatever their resources are and it looks like they are likely to go under. What that would prompt on our part is doing some kind of an audit. Sending people out to the school and identifying what the circumstances are directly. Obviously there is some time lag with financial statements. Making sure that things haven't turned around. Once that is identified as a consistent problem, then they will have to get into action that we take to eliminate the school from the program.

MODERATOR STANTON: Does that mean you have authority unilaterally?

MR. SOLOMON: Of course, there is an appeals process as other people have suggested.

MODERATOR STANTON: Can you pull the advances or do you have to go through process before you withdraw your advances to them?

MR. SOLOMON: We have to go through due process. Even if we have identified a school as being problematic and with issues, we have some action we can take. We do have what we call putting them on reimbursement. Meaning, we can require them to provide information on students prior to giving them funds. But if they already have our funds, we have to continue allowing them in the program while they are going through the appeals process.

MODERATOR KESTERMAN: Steve, are we only talking about proprietary schools -- truck driving schools? Or have you actually experienced losses from bona fide colleges?

MR. SOLOMON: I would say the predominant losses that we get are from proprietary schools. Again, one of the issues that we view and why it offsets the risk -- for instance, a public school -- our view is that if you've got the full faith and credit of a state, for instance, the risk that we take with that school is so diminumous because we can always recover anything from the state. Whereas, from proprietary schools it is another story.

MODERATOR KESTERMAN: Questions? How about dollar losses? What is the size of a normal loss that you might experience?

MR. SOLOMON: From these schools?

MODERATOR KESTERMAN: Yes.

MR. SOLOMON: You know, it would range -- and again, the issue winds up being whether it is a fraud situation or not. You know, we have had fraud situations that I worked on that the losses were in the millions. There is one particular case where it was somewhere around 45 million dollars -- where they absconded with money. Again, whether it is a complete loss, obviously then the FBI gets into it and there is a number of efforts that are made to try to recoup those. Generally speaking, what we are trying to do is before a school would close down, we would try to catch it and stop the loss of funds. The other concern we have -- I mean, our biggest concern is that we have to watch out for the federal funds, but our biggest concern is that the kids are not getting the services that we had supported. What we don't want it to do is we don't want a school to close down in January with kids halfway through school. So we want to make sure that they are in good shape before we wind up providing them with services.

MODERATOR STANTON: Tomorrow, we are going to hear from bank regulators in the morning and then others in the afternoon that essentially get the type of information you are talking about on a real time basis. Is there any sense that one can begin to close that gap? Presumably audited financial statements, it is probably plus six months by the time you get it. Is there any way to close that 18-month gap or in fact, if you guys looked at the financial analysis, you can't do much about it or it is not an issue?

MR. SOLOMON: Yes. The trade-off is we could require more current information to come in. The positive side, of course, about audited financial statements is we have independent verification by the auditors rather than just having a school send us the information themselves. That is a big plus. One of the things that we had looked into was there is an electronic methodology that the department is trying to collect information on our resource end. It is called IPADS. Where they are trying to collect information from the institutions audit information electronically rather than getting it hard copy. And that could really speed things up for us as far as the route that audits tend to take in the Federal Government.

Also, the main thing is moving toward electronic transmission of data rather than having to get the information hard copy, re-key it, and the possibilities of errors and just the time that is involved in that.

MODERATOR STANTON: You said one half. Is there --

MR. SOLOMON: Well, I mean getting the information and making sure that it is accurate and having the independence is a real good thing. Obviously, getting it quicker is a real important issue to us, especially in issues where there is the potential at all for fraud. Because we don't want to be waiting for a year after a financial statement to go out to a school once we have identified a problem. If it is problematic, we want to kind of jump on it right away. So, hopefully we can move in that direction.

MODERATOR STANTON: Thank you again.

MODERATOR KESTERMAN: Any more questions? Well, thank you for being here. Come back tomorrow and bring your friends.

(Whereupon, at 3:50 p.m., the workshop was concluded.)